INCOMES POLICIES: THE CASE OF SCANDINAVIA

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

FIRST SESSION

OCTOBER 20, 1981

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

90-228 O WASHINGTON : 1982

J841-28

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(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

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INCOMES POLICIES: THE CASE OF SCANDINAVIA

TUESDAY, OCTOBER 20, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2237, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; and George R. Tyler and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for another in a series of hearings on incomes policies abroad.

Some weeks ago we heard about the Austrian incomes policy system for Mr. Siedel, the Austrian Under Secretary of Finance, and today we will hear from three witnesses: Pentti Kouri of New York University, Peter Lange of Duke University, and Andrew Martin of the Massachusetts Institute of Technology, on incomes policies in Finland, Norway, and Sweden.

Of course, there are vast differences between our economy and the economies of the three countries mentioned. We could not be convening at a better time to see whether there are some lessons that can be learned by us because we have now entered a period of recession at home in the United States which inevitably means higher budget deficits than otherwise would be the case, and there's reason to hope it means lower interest rates than otherwise would be the case. These are the two vehicles apparently which must propel us out of the recession if we are going to be propelled out of the recession at all, and I'm confident by some hook or crook we will be.

The question then is how do you avoid reigniting inflation on the way upward and outward? To the extent that this hearing on Norway, Sweden, and Finland is relevant, what you three scholars have to report is going to be very helpful. Perhaps, both in your presentations and in some of the questions which the committee will have of you afterward, we can cast some light on lessons useful today based on the experience abroad.

Each of you has a most scholarly prepared statement which under the rule and without objection will be placed in full into the record. May I say personally that the kind of work you three have been doing is just what I think American economists should be doing—getting down to cases with what other countries in our variegated world are up to. The time and effort you have spent on it is, from the standpoint of this committee, a really great contribution.

So simply in the order of where you are seated, Mr. Kouri, would you start off and tell us about Finland and ourselves?

STATEMENT OF PENTTI J. K. KOURI, PROFESSOR, NEW YORK UNIVERSITY, NEW YORK, N.Y.

Mr. KOURI. Thank you, Mr. Chairman. I am pleased to have this opportunity again to meet with you and discuss the important economic problems in our times and the particular problem of inflation. I will be happy to discuss the specific institutional settings of Finland, but I felt that I would focus my introductory remarks on some general issues of inflation in the small countries and say something about the Finish experience, and then address the problem that you raise in your introductory remarks, Mr. Chairman, the problem of this inflation in the American economy and what we might learn from the experiences of these small Nordic countries.

When we discuss countries such as Finland, Norway, and Sweden, or any of the small European countries or any of the small countries in the world economy, we must recognize the fact that by their very nature they are dependent on the world economy both in terms of inflation and in terms of stability of their growth and in terms of their employment. Indeed, the smaller an economy is in terms of its population and capital stock, the narrower is the range of products that it can support, given the small size of the domestic market, and it is only in those circumstances, through participation in world trade, that a small country can overcome the handicap of smallness and fully benefit from improvements in the standard of living made possible by modern technology and capital intensive, roundabout, methods of production. Without participation in world trade, the economy of a small country would reach a stationary equilibrium at a low level of per capita income. Indeed, the optimum scale of production relative to market size is a factor that Adam Smith already emphasized as a fundamental reason why small countries do have trade.

There are other considerations that I want to briefly mention to highlight the extreme importance that international trade plays in the economies of small countries.

One follows directly from this existence of scale of production. We might imagine an economy which is just large enough to support a highly diversified structure and be independent in principle from international influences, but in such cases such a small economy would have such a small influence in the greater sectors of the economy it couldn't possibly maintain competitive market structure. So international trade is also important in enforcing competition and economic efficiency and their complications.

Finally, we may note the fact that small countries are always critically dependent on imports of raw materials which their natural resource base does not allow them to produce domestically or, as in the case of Finland, their natural resource base is highly skewed so they have to export those natural resources in which they are richly endowed in exchange for those which are either unavailable or only available at very high cost.

So, in short, why smallness is important must be recognized as the key consideration because a small country cannot succeed economically without succeeding in world trade. And if you look around the world economy, we see that countries that have succeeded in their trade, small countries that have succeeded in exporting in world trade, are countries that have also succeeded in terms of economic growth. Successful countries that have been developing at all have exporting economies.

Well, now, if we draw the implications of that fact for macroeconomic management and the problem of inflation in particular, I would note the following points.

First of all, in a small economy the prices of a wide range of products are determined in the world market and that applies to export products and it also applies to products used in the domestic economy but products that compete with imports.

Indeed, in the Scandinavian countries, the so-called Scandinavian model is usually the framework within which these programs are thought of and this model divides the economy into an international competitive sector consisting of the export industries, and the import competitive industries and assumes that in those industries the prices of products are determined in the world market, given the exchange rate, and then the wage rates in the economy are determined by the rate of change in the prices at which products are determined in the world market and the rate of growth and productivity in the tradable sector of the international competitive sector of the country.

Then the other sector of the economy, which is the sheltered services sector, has to take wages as determined in the international competitive sector with the prices of products on the basis of markup.

So that the problem of inflation, the mechanism of inflation in the small countries, such as the Scandinavian countries, goes from the external of the international competitive sector to wages, and from wages in that sector to prices of products and services in the sheltered sectors of the economy.

So world inflation and exchange rates are the key to understanding the inflation process in a small economy.

The second point that I'll briefly note is that because of the concentration of their exports and the matter of the range of products—and this is certainly the case in Finland—these countries are extremely dependent on fluctuations in the world economy; and third, in terms of their imports, a large fraction of their imports are in the form of raw materials and therefore increases in import prices are directly linked to domestic production costs.

A final point that I want to remark on is that international competitiveness in these circumstances becomes a vital precondition of overall macroeconomic equilibrium. If we start on an equilibrium

situation in a small, open economy, and for one reason or another there's an increase in wages, the firms in the international competitive sector will not be able to pass on these wage increases into higher prices. Instead, there will be a decline in the profitability in the international competitive sector and firms will respond by cutting down production in marginal plants and wage increases will automatically result in an increase in unemployment in the international competitive sector. And in the small country, when there is a change in policy, there is an automatic mechanism that prevents wage increases from being passed on to prices and instead, wage increases result in unemployment in the international competitive sector.

In that situation it's against this background that I think we have to address the problem of incomes policy that is the subject of today's hearing, for if we have a situation where the world economy is basically stable so that prices of export products and import products are stable, a situation that prevailed in the world economy for all the Nordic countries for 20 years from 1951 to 1970—as I document in my prepared statement that I prepared for this session, import and export prices of all Nordic countries were virtually stable for 20 years, from 1951 to 1970 in U.S. dollars, and for Finland and Denmark they increased because of devaluations, but Norway and Sweden were able to maintain stability throughout this period so that for them import and export prices were virtually stable. So in those circumstances, we have an anchor price stability in the economy which is the stability of world prices.

Well, then you might argue or one might say that it is distinctly impossible to generate inflation as a result of an excessive increase in the domestic aggregate demand or as a result of a wage push or caused by some other factors, and indeed there are examples in the history of both Finland and the other countries where this has occurred, but as world prices are stable, such increases in domestic costs and prices will result and the loss of international competitiveness will result in an increase of unemployment, stagnation of investment activity in the international competitive sector, and this, in turn, will then moderate increases in domestic prices and wages.

In that sort of situation—that is, the kind of situation that prevailed in all the Nordic countries for this period that I described in my prepared statement—and the role of incomes policies in that international economic environment was basically to assist in the formation of wages in such a way that the level of wages that was achieved in collective wage bargaining would be consistent with the requirement of full employment on the one hand, and external equilibrium on the other; and such wage agreements would automatically also insure price stability in the economy because the prices of a broad range of products were given exogenously and were stable in the world market. This is the period from 1951 to somewhere around the end of 1970, but the important point that we must note is the important change that occurred in Finland and also in all the other Nordic countries is the loss of price stability in the world economy.

From 1970 to 1975, after 20 years of stability, export and import prices of the Nordic countries increased by 100 percent in average

terms of U.S. dollars, and from 1975 to 1979 by a further 43 percent. So in the 1970's—and the same trend has continued—there was an increase of 150 percent or so in prices of imports and exports and therefore in prices of all international tradable products in those economies, and obviously these countries now enter a completely different situation as far as the problem of price stability is concerned because the mechanism which previously insured price stability and they had to only worry about maintaining international competitiveness and full employment and profitability in the tradable sector, now no longer could insure price stability and no longer could insure international competitiveness, and I think it is this break in international environment that is the most crucial change from the first period of price stability to the period in the world economy in the 1970's, and it's for this reason that incomes policies or the mechanism whereby economic equilibrium was so successfully maintained in all the Nordic countries in earlier times—why this mechanism failed in the 1970's in producing stable prices or moderate inflation simultaneously with steady growth in the economy and high levels of employment.

I argue in my prepared statement that an appropriate response would have been from the early 1970's to appreciate the currencies of those countries, to revalue year by year, month by month, quarter by quarter, so as to maintain the prices of international trade products stable, and that failure to do so rendered all other attempts to control inflation irrelevent.

Let me note here that in Finland in the early 1970's income settlements were quite moderate. The mechanism that operated such things previously continued to operate successfully and produced wage settlements that were quite moderate, but when in 1 year, for example, in 1975 export prices increased by 60 percent, it was quite obvious that firms in the export industry were in a position to pay wages far in excess of wages arrived at in the collective-bargaining agreement and, consequently, there was wage drift that caused an increase in wages much in excess of those increases agreed upon in wage settlements.

In conclusion, the system that was so successful in the earlier times broke down in the course of the 1970's because of the loss of price stability in the world economy and the change in policy which would have been the appropriate response.

Well, I conclude with the following question: Given that these countries now have imported world inflation into their economies and inflation has been entrenched in the domestic wage-price process, how can they get back to price stability with high employment and growth in their economies?

I think it is in that sort of situation that incomes policies become relevant, but I repeat, in my judgment, incomes policies cannot work in an environment of high world inflation in countries with fixed exchange rates. But in trying to get back to price stability and in trying to use exchange rate policy to stabilize domestic prices, incomes policies do play a role and they play a role very much the same way that I believe they might be useful if applied also in the United States.

A fundamental reason why it is difficult to get down to low inflation and get down from high inflation to low inflation, once infla-

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tion has become entrenched in the wage-price process is the following: When firms set prices, they set prices with a view to prices they expect other firms to be setting as well as with a view toward the level of aggregate demand in the economy.

Now if the Government announces that they are going to from now on pursue aggregate demand policies that are not consistent with price stability and the Federal Reserve—and now I'm referring to the United States obviously—announces that they are going to pursue monetary policy that is going to produce price stability in the long run, well, the firm may believe that is so—they may believe that the Government is going to pursue these kind of policies, but it is not convinced that the other firms believe the same thing but, instead, they assume that the other firms are going to increase their prices and therefore they will continue to increase their prices. So I think this is the catch of the inflation program, that to get down from high inflation it is not only necessary to convince a firm who is a price setter—and the same point applies to the labor market as well—convince the firm that the Government is serious, it is also necessary to convince this firm that other firms will think and behave in the same way.

So there has to be a mutual reduction in inflationary expectations and in this sort of situatior incomes policies or guidelines or whatever you may call them become useful because then firms know—and in the labor market individual trade unions know that it is not only them who are reacting and lowering their wage demands, lowering their prices, but other firms are doing the same because all of this is happening in the framework that insures it.

The same is true as far as the problems with small countries are concerned. I have argued that in Finland and all of these other countries they should revalue their currency so as to prevent the importation of world inflation. Well, if this is all that is done, the result of this is loss of international competitiveness in the export sector and an increase in unemployment and all the problems that come with it. Incomes policy can, again, play a useful role and this is the way that issues have been discussed in Finland—they have not resulted in action but they have been discussed—incomes policy can again play a role in that it convinces—it provides a framework where firms know and labor market parties know that it is not only them who are lowering their price and wage demands; everybody is doing it in a coordinated sort of way. So we are mutually assured of disinflation, as Sir James Tobin has called it.

Whether in a large economy such as the United States by monetary policy, or in the small economy such as Finland, Sweden, and Norway by means of exchange rate policy, incomes policies I think can play a useful role in achieving this objective; that all the different parties in the products price and wage determinations know that everybody else is doing what they are doing; and when that happens we indeed can achieve a reduction in the rate of wage-price inflation without excessive cost in terms of unemployment or economic growth.

Mr. Chairman, I did not say very much about Finland and the specifics of the Finnish experience. I will be happy to do so in an-

swering your specific questions and I stop at this point. Thank you very much.

Representative REUSS. Thank you, Mr. Kouri.

[The prepared statement of Mr. Kouri, together with an appendix, follows:]

PREPARED STATEMENT OF PENTTI J. K. KOURI

The Problem of Price Stability in Small Open Economies: Reflections on the Experience of Nordic Countries

Mr. Chairman: I am pleased to have this opportunity to meet again with the Joint Economic Committee, this time to address the problem of inflation and macroeconomic stability in small countries. I shall first discuss some general issues, and then some implications of the experience of Nordic countries in the postwar era. I shall be happy to answer more specific questions of interest to this committee.

The importance of trade

We must recognize from the outset that small countries are by their very nature highly dependent on the world economy both in terms of price stability and in terms of stability, and growth, of output and employment. The smaller an economy is in terms of its population and capital stock the narrower is the range of products that can be supported by the domestic market given economies of scale in production, investment, research and development, and marketing. It is only through participation in world trade that a small country can overcome the handicap of smallness and fully benefit from improvements in standard of living made possible by modern technology and capital intensive, roundabout, methods of production. Without participation in world trade, the economy of a small country would reach a stationary equilibrium at a low level of per capita income. The optimum scale of production relative to market size—a consideration already emphasized by Adam Smith—is a fundamental reason why a small country cannot sustain economic growth under autarchy.

There are three other reasons that we must consider. The first directly follows from the existence of scale economies which are significant relative to market size. We might imagine an economy which is just large enough to support a fully diversified production structure technologically with one or two firms in each line of production. It is obvious, however, that such an economy could not support a competitive market structure. Participation in world trade solves this problem and enforces competition and economic efficiency, a point of great importance in all small countries.

Another consideration has to do with the fact that the natural resource base of most small countries is typically very narrow forcing them to export their relatively abundant resource in exchange for resources that are relatively scarce if not nonexistent. Finland, for example, is very rich in forests but poor in most other natural resources, such as metals and fossil fuels. Under autarchy, the marginal value of Finnish forests would be very low, because the resource endowment is so large relative to the size of the domestic market, whilst the relative price of energy and many metals would be extremely high. International trade enables Finland to exchange its relatively abundant resources in the world market at much higher relative prices than what would prevail in the domestic economy under autarchy, and thus considerably increase the economic value of these resources.

A final point concerns the dynamic effects of international trade. In the final analysis capital accumulation in its many forms is the basis of all improvements in material welfare. Although major scientific discoveries have occurred, and probably will continue to occur, without substantial capital expenditure, their development and adaptation into economic use requires, almost without exception, capital accumulation and capital replacement. Economic growth continues as long as the role of private return to capital investment exceeds the opportunity cost of such investments in terms of sacrifice of current consumption, and growth comes to a halt when new investment projects cannot be profitably undertaken. In small closed economies such saturation point is reached at low levels of affluence, and accordingly participation in trade is vital not only because of its static welfare and efficiency effects but also because of its dynamic effects on growth and development.

There is no escape from these economic and technological laws. To develop, a small country must participate and succeed in world trade. For a quarter of a century after World War II the world economic environment was favorable to small

countries. Almost without exception, countries that chose an outward looking, export-oriented development strategy succeeded, whilst countries mostly in the developing and underdeveloped world, that opted for an inward looking development strategy failed in generating self-sustaining economic growth. Many of the developing countries were further hurt by the fact that because of their failure to adjust, their production and export structure inherited from colonial times worked against them, as the relative prices of raw materials declined for twenty years after 1951. This development was, I believe, incorrectly diagnosed by Rauol Prebisch as a justification of a strategy of import substitution. Indeed, as we know from the extensive work of Bhagwati, Krueger, and others, tariffs, multiple exchange rate practices, and restrictions on currency convertibility that were the instruments of the inward looking strategy, were in a major way responsible for the economic stagnation of the countries that pursued such strategy.

Openness and macroeconomic dependence

Whilst openness is the only to affluence in small countries, it also exposes them to fluctuations in the world economy which instruments of macroeconomic policy cannot always easily offset. At the same time, openness to the world market makes "internal competitiveness" a crucial precondition of the maintenance of full employment and economic growth. Indeed, the essence of macroeconomic policy in small countries is on one hand how to alleviate the domestic impact of fluctuations in the world economy and on the other hand how to maintain international competitiveness with full employment and price stability.

The period of stability, 1951–70

As far as the first problem is concerned, I already noted that until the 1970's the small countries of Europe were able to develop in an extraordinarily stable international environment. From the 1949 to 1973 the total output of industrialized countries increased at an average annual rate of 4.9 percent in comparison with an average growth rate of 2.3 percent in the chaotic interwar period, while world trade increased by as much as 9 percent per year on the average. Unlike in previous decades, there were no prolonged interruptions in the steady expansion of the world economy. In Europe, for example, there were only four brief growth recessions before the global recession of 1974/75, namely in 1952, 1958, 1967, and 1971. Recovery from each of these "slowdowns" was fast, and in every year except for these 4 years growth was above 4 percent per year. It is true, of course, that stability of growth in the aggregate hides sharper fluctuations in individual economies and in individual industries of significance to a particular small country. Finland's export demand, for example, has always fluctuated more shareply than total world trade because of the cyclical sensitivity of the forest industry Finland's major export industry.

Nevertheless, until the early 1970's real economic development in the world was favorable to the small countries. Small countries were further aided by the process of trade liberalization within the framework of GATT, and the generally liberal trade policies pursued by the large countries.

In terms of price stability, too, small countries benefitted from an extraordinarily stable world economy until the latter part of the 1960's. For the Nordic countries, for example, there was virtually no increase in the dollar prices of exports and imports from 1951 to 1970 (see table I). The same holds true for other small countries as well. During the same period the prices of raw materials, including oil, decreased continually in real as well as in nominal terms.

As long as the dollar prices of world trade remained stable, the policy of pegging the domestic currency to the U.S. dollar within one percent margins, as was required under the Bretton Woods system, amounted to a de facto commodity standard for the small countries. Such policy insured a stable purchasing power of domestic money in terms of internationaly traded goods and services as long as the exchange rate remained fixed and as long as the international purchasing power of the U.S. dollar remained stable.

In this environment of stability, the main problem of macroeconomic policy was to control domestic aggregate demand, and domestic price and cost developments. The record is mixed in this respect. All Nordic countries were able to sustain high rates of growth throughout the post-war period with Finland exhibiting greater cyclical fluctuations than the other countries. Only Norwary and Sweden managed, however, to keep their cost development in line with requirements of external balance at a fixed exchange rate, while Finland had to devalue twice, in 1957 and in 1967, and Denmark once in 1967, before the currency realignments of the 1970's.

The Scandinavian model

In the Nordic countries the problem of macroeconomic equilibrium came to be seen in terms of the so-called Scandinavian model of inflation developed in Norway by Odd Aukust and in Sweden by a team of labor market economists, Edgren, Faxen and Odhner (their model is commonly referred to as the EFO model). The Scandinavian model divides the economy into two sectors, very much like the Australian dependent economy model of Salter, Swan and Corden: a sheltered sector not directly exposed to international competition, and an exposed sector consisting of export industries and import competing industries. The model assumes as an approximation that the prices of exports and import competing goods are determined exogenously in the world market (given the exchange rate). In equilibrium, the rate of wage (or labor cost) increase in the exposed sector must then be equal to the sum of the rate of productivity increase and the rate of increase of the prices of traded goods. Labor market equilibrium, or in some interpretations "solidarity", requires that wages in the sheltered services sector equal manufacturing wages. The prices of products and services in the sheltered sector are then determined by a markup on unit costs. This implies, in particular, that the relative price of nontraded goods in terms of traded goods increases in equilibrium at a rate equal to the difference between the rates of productivity growth in the exposed and sheltered sectors. Because this difference has been typically positive, the productivity factor has generally imparted an inflationary bias on the economy.

As I have argued elsewhere the Scandinavian model cannot be viewed as a descriptive model of the inflation process, but rather as an approximation of equilibrium conditions that can provide a useful framework for arriving at reasonable income settlements. This is, of course, how the model has been applied in Norway and Sweden, and also to some extent in Finland. It is important to remember, however, as Assar Lindbeck, Lars Calmfors and others have emphasized, that even if collective wage agreements were faithful to the Scandinavian equilibrium model, actual wage developments may be quite different if aggregate demand policy is not consistent with the requirements of stability. Thus, excessively expansionary aggregate demand policies can lead to a wage drift and a decline in international competitiveness, as indeed happened in the Nordic countries in the early 1970's. Equally important, it should be noted that "incomes policy", interpreted broadly to include "responsible" collective agreements can ensure price stability only if world prices are stable, as they were until the late 1960's. With the explosion of world prices in the early 1970's the emphasis placed on labor market agreements became irrelevant, because external price shocks and monetary expansion became the driving forces of inflation. Failure to recognize this and to use exchange rate monetary policy to offset importation of world inflation in the early 1970's must be counted as one of the major failures of policy in the Nordic countries in the post-war period.

Macroeconomic policy in an unstable world economy, 1970–81

Since the early 1970's, the main problem of macroeconomic policy in small countries has been the instability of the world economy both in terms of growth and inflation.

As far as inflation is concerned a small country can, in principle, completely insulate itself from world inflation by revaluing its currency so as to stabilize the domestic currency prices of internationally traded goods. None of the Nordic countries, however, used exchange rate policy in this way but instead continued to peg their currencies in terms of currency baskets even after the collapse of fixed exchange rates. Tables 1 and 2 give an indication of the costs of this failure of policy. After two decades of stability, the dollar prices of exports and imports of the Nordic countries increased at annual rates well above 10 percent on the average from 1970 to 1979. This increase in dollar prices reflects both worldwide inflation and depreciation of the U.S. dollar in terms of other currencies. The external price shock was particularly severe in the first half of the 1970's, when the dollar prices of traded goods increased by over 100 percent from 1970 to 1975. From 1975 to 1979 there was a further increase of 43 percent in the average dollar price of traded goods. A policy of keeping the dollar price of domestic currency fixed would have had exactly the same economic effects as a devaluation of the domestic currency by 143 percent in terms of the U.S. dollar in the absence of any increase in world prices. Obviously, no government would have intentionally devalued by such a magnitude had dollar prices remained stable through the 1970's.

Yet the actual exchange rate policies pursued by the Nordic countries in the 1970's amounted to a substantial "unplanned" devaluation of the Nordic currencies in terms of international purchasing power. As is shown in table 2, the average domestic currency prices of traded goods increased substantially in all Nordic coun-

tries from 1970 to 1979, ranging from an annual rate of increase of 8.2 percent in Norway to an annual rate of increase of 12.6 percent in Finland. As is also evident from table 2, there was a similar acceleration in the domestic inflation rate as measured by consumer prices or wholesale prices. Whilst domestic factors undoubtedly played a role in the acceleration of inflation in the Nordic countries there can be no doubt that the single most important difference between the 1970's and the previous decades is the acceleration of world inflation. There can be no doubt either that the Nordic countries could have used exchange rate policy to offset the acceleration of world inflation.

As it happened, the acceleration of world inflation, together with domestic demand pressures led to an overshooting of domestic inflation in the Nordic countries above world inflation, and consequently to a loss of international competitiveness. For this reason, failure to revalue early forced the Nordic countries to devalue later in the second half of the 1970's to restore international competitiveness.

As far as the two oil shocks are concerned, the experience of the Nordic countries is different from that of many other small countries. Norway is, of course, a unique case as an oil rich country and has experienced a major improvement in its international forms of trade. Denmark is more like the other oil consuming countries in that it experienced a terms of trade deterioration both in 1979 and in 1979–80. Finland and Sweden, in contrast, experienced an improvement in their terms of trade after the first oil shock because of a sharp increase in the export prices of paper and pulp in 1974–75. It is only after the second oil shock that both Finland and Sweden have experienced a sharp deterioration in their terms of trade. Thus, for Finland, Norway and Sweden the major problem in the 1970's was inflation, rather than a deterioration in the terms of trade. Exchange rate policy could have been used to deal with this problem. Because it was not used, world inflation was imported and became entrenched in the domestic wage-price process with adverse consequences in terms of international competitiveness, growth and employment.

APPENDIX

TABLE 1

THE NORDIC COUNTRIES: INTERNATIONAL PRICE DISTURBANCES

(Logarithmic Annual Rates of Change of Dollar Import and Export Prices)

		1950-1951	1951-1970	1970-1979
Denmark	Import Price	24.3	-0.5	12.9
	Export Price	12.0	0.5	11.7
Finland	Import Price	31.5	-0.8	13.6
	Export Price	63.4	-1.1	13.2
Iceland	Import Price	14.3	-0.9	9.3
	Export Price	11.4	1.7	13.1
Norway	Import Price	17.4	-0.2	11.7
	Export Price	31.8	0.4	12.5
Sweden	Import Price	23.0	1.0	13.1
	Export Price	48.0	0.4	12.5

Source: International Financial Statistics, 1980 Yearbook.

TABLE 2

THE NORDIC COUNTRIES: INFLATION
(Average Annual Rates of Change)

1. 1951 - 1970

	Denmark	Finland	Iceland	Norway	Sweden
Trade Prices	0.5	2.3	10.6	0.5	0.2
Wholesale Prices	0.5	3.2	----	2.2	----
Consumer Prices	4.2	4.2	9.0	3.9	3.7

2. 1970 - 1979

	Denmark	Finland	Iceland	Norway	Sweden
Trade Prices	8.4	12.6	25.9[a]	8.2	10.0
Wholesale Prices	8.5	10.7	----	7.5	9.2
Consumer Prices	12.3	10.6	41.4	7.8	8.4

Source: International Financial Statistics, 1980 Yearbook.

TABLE 3

THE TERMS OF TRADE 1970-1980

	70	71	72	73	74	75	76	77	78	79	80
Denmark	100.0	100.0	101.1	103.0	88.9	93.8	93.8	91.3	94.6	89.6	82.6
Finland	100.0	98.5	98.9	99.7	98.3	106.4	102.4	102.1	97.1	95.0	91.0
Iceland	100.0	113.0	111.7	128.9	116.1	99.3	111.8	121.3	122.0	110.3	104.5
Norway	100.0	98.8	97.3	99.4	104.2	106.5	101.5	100.9	102.1	107.2	112.6
Sweden	100.0	100.2	101.9	99.1	93.8	103.6	103.6	98.5	96.7	93.1	

Source: International Financial Statistics

TABLE 4

GROWTH OF THE NORDIC COUNTRIES
IN HISTORICAL PERSPECTIVE

(Annual Rates of Change)

	1950-60	1960-73	1973-1980
Denmark	3.2	4.6	1.6
Finland	4.9	5.4	2.7
Iceland	4.7	5.4	---
Norway	3.5	4.3	4.2
Sweden	3.4	3.9	1.7
OECD	4.1	5.0	2.9

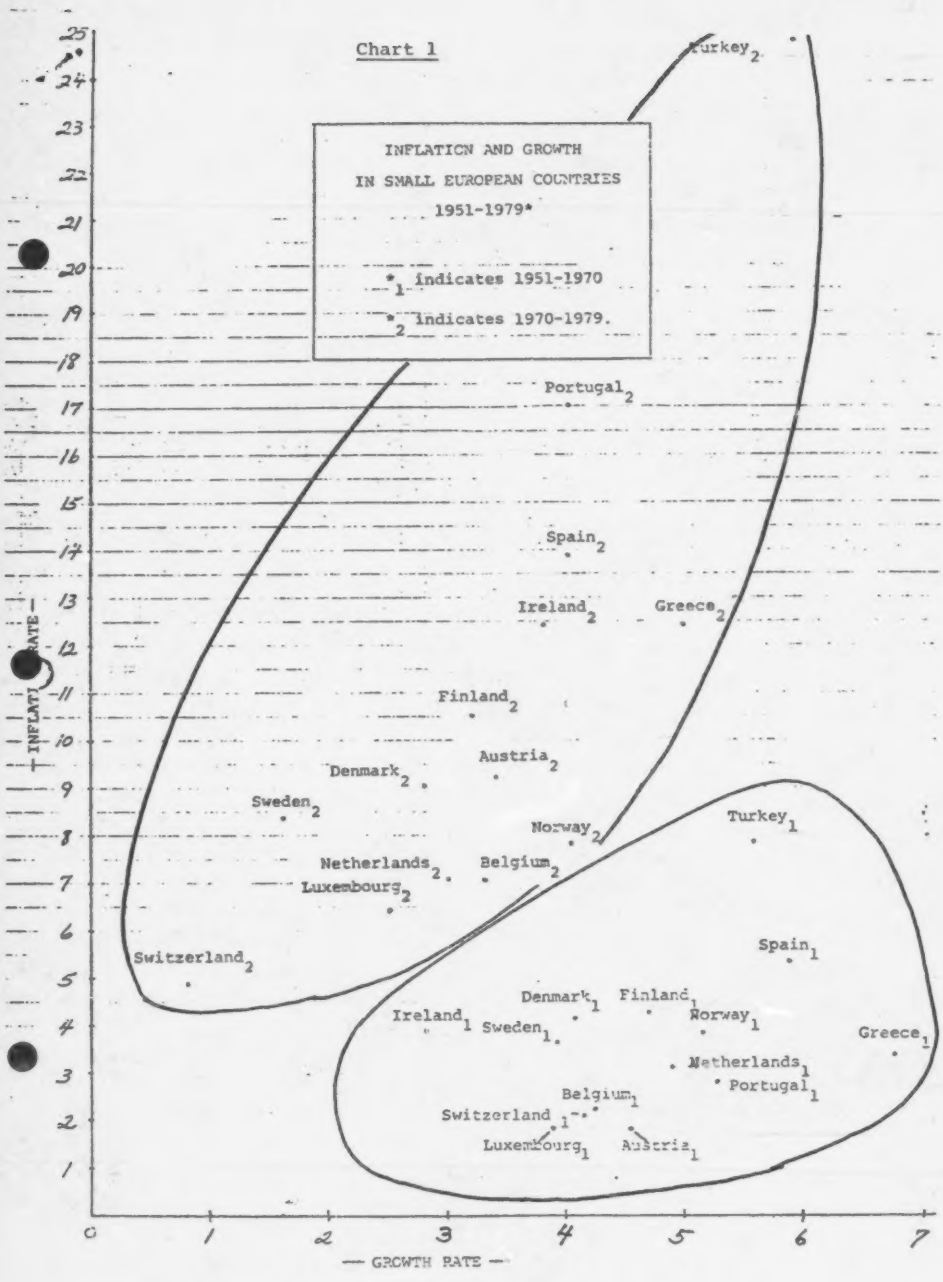
Chart 1
INFLATION AND GROWTH
IN SMALL EUROPEAN COUNTRIES
1951-1979*
*1 indicates 1951-1970
*2 indicates 1970-1979.
INFLATION RATE
GROWTH RATE
Turkey2
Portugal2
Spain2
Ireland2
Greece2
Finland2
Austria2
Denmark2
Sweden2
Norway2
Netherlands2
Belgium2
Luxembourg2
Switzerland2
Turkey1
Spain1
Denmark1
Finland1
Norway1
Ireland1
Sweden1
Greece1
Netherlands1
Portugal1
Belgium1
Switzerland1
Luxembourg1
Austria1

Representative REUSS. Mr. Kouri, without interrupting the flow of testimony, I would like to sharpen one point.

Is this what you're saying: That in a time like the present where the industrialized democratic world is undergoing a recession and where budget deficits and lower interest rates caused by the recession may also be the thing that proves helpful in getting out of the recession, that such a time—in the months and quarters ahead—is a good and propitious time for incomes policies if ever there is one? Is that what you have said?

Mr. KOURI. Mr. Chairman, indeed so.

Representative REUSS. Both for small countries like the Nordic ones and for large ones like the United States?

Mr. KOURI. Indeed, sir. They play a useful role in the transitional phase and I think they can reduce the cost of transition to lower inflation both in terms of unemployment and in terms of loss of output.

Representative REUSS. Thank you. We will return to that.

Mr. Lange, please proceed.

STATEMENT OF PETER LANGE, VISITING ASSOCIATE PROFESSOR OF POLITICAL SCIENCE, DUKE UNIVERSITY, DURHAM, N.C.

Mr. LANGE. Thank you, Mr. Chairman. It's a pleasure for me to address this distinguished committee this morning. I want to make clear that I have come to the issue of income policy from the standpoint not of an economist but as a political scientist, which therefore has made me more interested in the institutions through which income policy has been fostered than in the specific narrower economic questions. However, I will address those in the course of my remarks because they are obviously inseparable.

As I have already indicated in my prepared statement, I think that the efforts of this committee can provide a better understanding of the economic and political problems faced by some of the U.S. allies and friends, thus perhaps contributing to our foreign economic and political policy and can as well provide guidance about how future attempts to implement some form of income policy in this country might best be organized.

The relevance of foreign experiences for U.S. policy is always an issue which must be dealt with cautiously. This is especially so in the case of income policies because the size of the U.S. economy, its relatively low, by international criteria, dependence on exports, its low rate of unionizaton, the diversity and the decentralization of the U.S. union movement, and the absence of the tradition of centrally reached accords on wages and prices all make our political economy very different from that of the European countries that have most successfully used income policies in combination of other techniques of macroeconomic management as basic instruments of their political economic policy.

Nonetheless, an analysis of the comprehensive centralized income policies in these countries may be instructive for more limited efforts here. I have already submitted a lengthy analysis of income policies in Norway to the committee. I will, therefore, confine my remarks here to underlining the features of the Norwegian experience which may be of greatest relevance in the context of

thinking about income policy in the United States. In doing so I will both underline some of the things that make Norway very different from the United States and some things which I think can nonetheless be constructive for our own policy thinking.

There are six major features of the Norwegian income policy which should be underlined. First of all, it has been an ongoing central instrument of Norway's macroeconomic policymaking throughout the postwar period. It has not therefore been a temporary measure to deal with a temporary emergency but, rather, has been considered essential to dealing with Norway's domestic and international political economic needs in the context of an underlying highly organized economy.

Second, its basic objectives are reflective of the perception of these needs. These objectives have been: one, to maintain and assure the competitiveness of Norwegian exports in the international economy; two to maintain an economy at full or near-full employment; and three, to maintain and develop as much equity in the structure of Norwegian wages as is possible, given the first two goals.

Third, in order to achieve these objectives, it has been deemed necessary to control inflation, especially in the export sector, keeping it below levels which would damage competitiveness but to do so without using unemployment to discipline the wage-setting process.

It has also been deemed necessary to maintain high levels of investment, especially in export and import substituting industries. The rate of investment in Norway in the postwar period is quite noteworthy.

A fourth feature of the Norwegian system of income policy as it has been applied to wages is that it has been voluntary, but with major participation by the government. Only on rare occasions has the government resorted to direct authoritative intervention in the wage-setting process. Instead, the government's role can be described in terms of three basic functions: one, as a facilitator, developing the institutions within which the national union federation, the LO, the national employers' association, the NAF, and the associations of the other major economic interests could arrive at technical estimates of the state of the economy and the consequences of different nationally agreed on wage and price settlements.

Therefore, government has sought to create a setting for the meeting of these actors to facilitate the working out of both the technical and political aspects of their coming to agreement.

The government has also played the role of what I would call a guarantor, helping to assure that such agreements would be carried out and that government policy would be consistent both with these agreements and with government commitments as part of those agreements, and I will return to that point later, but clearly, as Mr. Kouri said, it relates to the importance of predictability in the system as a whole.

The third major role of government has been as a compensator, offering benefits to various of the economic sectors and the individuals within them in exchange for the restraint with regard to wages and prices.

By playing these roles, the government has made it easier for the Norwegian unions to restrain wages without severe dissent from the member unions of the LO or from the workers. But government has not generally intervened directly to set or freeze wages. There are, however, exceptions in that regard.

Fifth, as the preceding suggests, the Norwegian system has been highly centralized. Only 3 of 14 wage agreements since 1962 have been reached at the individual union rather than at the centralized LO level. The LO has been generally able to deliver its member unions and these unions, in turn, have been able to deliver their members for agreements reached at the central level.

The sixth and final feature is that over the history of the Norwegian system and especially since the mid-1960's, there has been an increasing tendency for the scope of the agreements reached at the center to expand. By this, I mean that the restraint of wages has been linked to agreements about the movement of an increasing number of other prices, and the level of a wide variety of government policies during the contract period. The so-called "combined agreement" of 1976 is an example of this. In that case, the agreement with respect to the restraint of wages was coupled to accords on taxes, salaries, pensions, food prices, child support payments, farm support prices, and a variety of lesser government policies.

It may be of particular interest to this committee, given its legislative function, that this package agreement was reached among the major interest associations and the government in a nonlegislative forum, but had to be ratified by the Norwegian Parliament as well as by the Norwegian workers.

Now after this brief review of the Norwegian system of incomes policy, two questions seem to me to be appropriate, and I will address each briefly.

First of all, how well has it worked? And second, what are the institutional conditions which have allowed it to work as well as it has?

I would say on balance that the postwar system of incomes policy in Norway must be judged a success. I review data in support of this judgment in my prepared statement. In brief, the system has been associated with relatively high rates of growth, very high levels of investment, moderate but not extremely low rates of inflation, strong international competitiveness for goods for which the demand is highly price sensitive, very low rates of unemployment, and rather low strike rates.

This strong record was particularly evident until the last decade, until approximately 1970. On this point my remarks parallel those of Mr. Kouri. Since that date and especially since 1973, the record is more spotty.

The 1974 wage agreements produced an undesired inflationary impulse. Equally as important, the government, perhaps enticed by the prospect of oil revenues and the foreign surplus that might result therefrom, pursued overstimulative policies, especially through subsidies and social welfare policies.

The combined agreement of 1976, while it appears to have helped bring wages back within the parameters set by the economic model, nonetheless was so stimulative in other areas covered that the most sensitive of indicators, the competitiveness of Norwegian

goods, suffered a sharp decline. Norway lost a significant share of her export markets in this period.

It was this situation which led to the 15-month wage-price freeze and the invocation of government standby authority in 1978–79.

While the freeze restored some equilibrium, three things have become clear about the recent period. First, the expanding scope of the agreements can not assure the achievement of the macroeconomic objectives if the government is unable or unwilling to impose discipline on all the actors. This is ironic because part of the reason for expanding the number of policy areas brought into the agreement is precisely to make wage restraint more tolerable for the actors in a situation in which the economy is tightening and where the restraint must be greater than in the past.

Second, the incomes policy is not well adjusted to deal with the emergence of oil revenues as a major factor in the Norwegian economy.

And third, more generally, even an incoming policy system as well developed as that in Norway is strained by the kinds of developments in the international economy which we have seen in the last decade.

If we turn now to the issue of why, from an institutional standpoint, the system has worked as well as it has and to how some of these factors may be of relevance for the U.S. possibilities, I would just briefly go through a few points.

I have discussed a number of the factors in the specific Norwegian context in my prepared statement. I would like here just briefly to indicate some of the characteristics of what has been going on in Norway which might in a different institutional context also be useful here.

On the basis of my analysis of the Norwegian and other incomes policy systems, it appears that somewhat different factors contribute to their initiation and to their maintenance and effectiveness, and I, thus, think it is important to keep separated the questions of why systems like these—which have a long history—are maintained, from the question of under what conditions they can be initially put into place.

If we take up the startup question, the initiation of the Norwegian system and most of the others can be linked to situations of political and economic emergency. These are situations in which there is a widely shared perception of the public good and of the need to participate in achieving it.

All the major economic actors have a keen sense of the potential advantages of mutual restraint and cooperation and the risks of failing to exercise restraint and to cooperate. Under these conditions, it also appears possible for governments to impose rules and costs which would not be accepted under other circumstances.

In Norway, to take an example, incomes policy was initiated in the immediate postwar construction period with very strict controls on prices and sharp limits on the freedom of action of the trade unions. These limitations were not imposed, however, but were agreed on by the actors even prior to the end of the war.

More generally, most of the comprehensive and enduring postwar systems for incomes policy have their roots in the first few years after World War II, in what might be called the spirit of re-

construction—which spirit I might point out is different from the "spirit of reindustrialization."

What contributes to keeping these systems going once they are in place? On the basis of my examination of the Norwegian and other systems, I would stress the need of the following: First, predictability. The incomes policy system must enable all the actors, but especially the unions, the employers and the government, to be able to rely on the behavior of the other actors and on the ability of those actors to live up to their commitments. All the actors in an incomes policy system incur risks. These are especially clear for the unions. They are asking their members to restrain their short-run wage demands in order to promote public goods which presumably in the medium run will work to the benefit of the individual worker.

For that latter to happen, however, other actors must also restrain their behavior. Nonwage sources of inflation, for instance, have been a major source of disturbance in the postwar Norwegian system and the government has often used its price control authority to restabilize the system, particularly with respect to the agriculture prices, for example. This clearly links back to Mr. Kouri's remarks about instability coming from the outside through international price inflation.

It therefore seems the case that a stable incomes policy system requires a strong government with considerable scope for action on issues other than wages in order to insure stability in the system. This is an example of both the facilitator and the guarantor roles which I indicated earlier.

At least two other factors seem to contribute to the high levels of predictability which help maintain incomes policy systems.

First of all, it is clear that high degrees of centralization and coverage of the major economic actors are rather important. There should not, in an incomes policy system which is going to be effective, be a great deal of possibility to escape the agreements made by the central actors, either by simply opting out or by never being included in.

As an example, when the Norwegian system was instituted immediately after the war, the government extended, by law, agreements made by the unions and by the employers' association even to nonmembers in those two sectors, so that workers not within unions were covered by the agreements, and employers not within the employers' association were covered by the agreements. That was done legislatively at that time to insure the extent of the coverage of the agreement and to make sure that nobody could escape from agreements made.

Furthermore, it should be noted that Norwegian unionization rates are very high and that there are very effective rules for central control by the unions, although these should not be exaggerated, as my prepared statement indicates.

Also contributing to higher predictability is a good flow of information about the economy and its status. It is critical that this information flow not come from the outside, that it not simply be imposed by the government or provided by the government, but be an integral part of the process through which agreements are eventually reached.

The Technical Committee, which works for the Contact Group, which is the major forum in which Norwegian incomes policy agreements are made—the Technical Committee is composed of representatives from all the major actors—the unions, the employers, the agricultural sector, the fishing sector, the banking sector, plus the government—and it is in that committee that the model which was described by Mr. Kouri earlier and which is used also in Norway, is examined, and judgments are made about its implications for forthcoming agreements.

Now beyond predictability, let me stress two other factors which seem very important in maintaining an incomes policy system. First, there must be a constant sense of the risks of failure to cooperate, especially on the part of central organizations, but also among their members as communicated by their organizations. This has been clear in the Norwegian case and it is embodied, among other places, in the price elasticity of Norwegian export goods which is estimated to be almost one.

Third, it seems that for the maintenance of an incomes policy system—and I think this is extremely important in the U.S context—there must be a sense of equity within the system. That is, a sense that nobody is losing in the arrangement, that there is a relative protection of shares for the various economic sectors within the arrangement. In Norway, this is pretty much guaranteed by the institutions which give the major organizations a veto over agreements, but also by the government through its provision of compensation and guarantees. It is clear, however, that maintenance of shares is much easier when the pie is growing fast than when it is shrinking.

Finally, I would simply stress that it is clear that in these systems the experience of success and the experience of the costs of failure when the system has broken down are themselves a contributor to the long-term endurance of these systems. It is harder to get going than to stay going, to some degree.

Now if we apply some of these rules to the United States, it seems clear that to implement an incomes policy in this country under the conditions that you describe, Mr. Chairman, will be extremely difficult, as least if we understand it in its comprehensive sense. It will be difficult because the predictability in the system is low, because the ability of the central actors to act on behalf of their sector is relatively weak, and because we have really no history of such agreements or an experience of success with them.

However, I would argue that to the extent that institutions and rules and agreements can be structured in such a way as to increase predictability, centralization, and some of the other variables I have indicated, it may be possible, and certainly would seem on the basis of these foreign experiences desirable, to attempt to undertake an incomes policy under the conditions you describe.

That concludes my testimony, Mr. Chairman.

Representative REUSS. Thank you, Mr. Lange.

[The prepared statement of Mr. Lange follows:]

90-228 O—82——4

Prepared Statement of Peter Lange

Norwegian Incomes Policy in Competitive Perspective

It is a pleasure for me to address this distinguished Committee and to contribute to your extensive examination of incomes policy and general political economic policy in the advanced industrial democracies. While my testimony will indicate that I believe the possibility of implementing a comprehensive, voluntary incomes policy in the United States to be small, even were there the political will to do so, I do think there is much to be learned from looking at the experiences of other countries. Not only may it indicate some measures short of comprehensive incomes policy which may be of use in the Unites States and the conditions which would help increase the probability of success of such measures, but it can also contribute to a better understanding of the economic and political constraints under which many of our allies operate and which should be considered in formulating our foreign economic and political policies.

I come before the Committee as someone who is studying the conditions which promote incomes policy in a number of European countries and is attempting to use the comparative method to highlight those factors which seem most important in explaining the emergence, stability and breakdown of such policies. In this context, I have looked extensively at Norway which is in many ways an archetypical case. In presenting that case, however, I will try consistently to place it in a comparative context.

1. Introduction

If by voluntary incomes policy we mean a nationally coordinated system which, while maintaining trade union bargaining autonomy, seeks to achieve an ongoing leverage on wage movements in accord with national economic objectives, the postwar Norwegian system can be considered archetypical in two senses. First, descriptively, since World War II it has produced centralized, national tri-partite agreements to keep wages within parameters judged consistent with the maintenance of Norway's competitiveness in the international economy, with high rates of investment in the Norwegian economy and with full employment, while at the same time promoting wage equity within the Norwegian workforce. The chief participants in these agreements have been: 1) the national, peak federation of the Norwegian unions, the LO (Lands organisasjonen); the national association of employees, the NAF (Norges Arbeidsgiverforening); and the government, which for most of the postwar period has been headed by the Norwegian Labor Party (DNA). There have been occasional breakdowns of the tri-partite, centralized process, and success in implementing central agreements and attaining the desired objectives has not always been achieved, but with the exception of the Austrian, no other European system has so closely and consistently matched the understanding of incomes policy suggested above. Analysts, including the O.E.C.D. furthermore, are generally agreed that the system has been relatively successful in achieving its objectives, at least until the mid-1970's. Second, the Norwegian system is also archetypical from the standpoint of explanation. Almost all of the factors which a comparative analysis of incomes policies in Europe indicates are conducive to the development and maintenance of such a policy have been present in Norway. In light of the preceding, therefore, the Norwegian case may be particularly illuminating of the tensions and factors which, even in a system well-suited to incomes policy, may lead to partial or complete breakdown.

2. The Norwegian System: A Brief History

The postwar experience of Norwegian incomes policy can be broken down into three phases: 1) 1946-1952, when there were direct controls on prices and the wage setting process was highly centralized and monitored, with the full consent of the trade unions; 2) 1953-1962, when there was a withdrawal from controls, a partial relaxation of strict monitoring and formal centralization of the wage setting process and a general reduction in the direct role played by government in that process; 3) 1963-present, when new institutions for coordination were developed, when more formal and explicit criteria were formulated in light of which wages were to be set, and during which there has been a growing tendency to extend the scope of issues covered by centralized tripartite and multi-partite negotiations among the major interest associations and the government.

Phase 1 - Reconstruction

The Norwegian economy emerged from the war with a significant part of its industrial base destroyed. It has been estimated that almost twenty percent of Norwegian capital stock was lost during the war. In addition, postwar economic policy faced the problems of significant suppressed inflation, a historical problem of structural unemployment and a shorter-term threat of unemployment due to adjustment to non-war, non-occupation conditions. Furthermore, Norwegian economic and political elites were keenly aware that the ability of the postwar Norwegian economy to contend with these problems would depend on its ability to compete internationally, in particular on its ability to build up import-saving and export industries.

To contend with the problems before it, the Norwegian government - led for the first-time by the Labor Party with an absolute majority in the Storting - undertook what might, with some irony, be called a centrally-coordinated "supply-

side" policy. The goals of high rates of production and full-employment were controlling. Programs were implemented to assure high rates of investment, to limit price increases through controls and, consistent with these efforts, to limit consumption. (Private consumption form 1946 to 1950 was to be kept to an average level below that of 1939.) A so-called "stabilization line" for price and cost increases was established and it was made clear to all parties that the government was willing to try to hold this line through sanctions. Importantly, however, no drastic monetary reform was undertaken; the system of controls was a substitute, deemed more consistent with the intention rapidly to rebuild and develop the country's economic base.

Wage policy and movements were clearly central to the government's overall effort. A number of measures were undertaken to assure that wages remained relatively low. Legislation was passed at the end of the war stipulating that all changes in wages in the economy, whether the relevant unions or employers were members of the major trade union organization (LO) and employers' association (NAF) or not, would have to be centrally negotiated by these organizations. Furthermore, if there were disagreements, they were to be subjected to compulsory mediation and, that failing, compulsory arbitration. At the same time, the consent of the LO to a strict regime of wage regulation was won, thus assuring that these centralizing structures would operate without undue friction. After 1949, the stipulation of compulsory arbitration was removed from negotiations at the central level, while it was maintained for all disagreements below the peak.

It is clear that the system for incomes policy in this period was a strict one, that government was heavily involved and that it was part and parcel of an overall centrally-controlled effort to rebuild the economy consistent with longer-term national economic strategy. What should be underlined, however,

is that government remained at arms length (albeit a short-arm) from the process of wage bargaining between the LO and NAF. It created the structures which made centralized bargaining necessary and which promoted its efficiency and effectiveness. It provided the assurances to the unions that movements in other areas of the economy, especially prices, would not undermine the sacrifices which workers were being called on to make. It provided the legal structure and machinery for compulsory mediation and arbitration. But, it did not directly control bargaining results but rather sought to influence the bargaining partners. The unions, it should be noted, were particularly concerned to maintain their formal bargaining autonomy and their distance from a government controlled by the political party with which they were closely tied.

Phase 2 - Partial Relaxation

The program of the first phase had brought Norway considerable economic success by the early 1950's. At the same time, however, with much of the recovery task accomplished, the controls threatened both to lead to inefficiencies and to promote considerable tensions within the associations of the major economic actors. Thus, both for economic and political reasons, some relaxation of the tightly controlled and centralized political-economic decision-making process seemed advisible.

There were a number of symbolic and practical steps taken in this direction. The LO in late 1951 called for an end to the system of peak level bargaining thereby allowing the individual unions to negotiate their own contracts. Among other things, they noted that the centralized and tightly controlled system tended overly to reduce wage differentials both within and between industries, thus dampening the necessary adjustments in demand for skilled labor. The LO also sought an end to the provisions for compulsory arbitration, which was accomplished at the end of 1952. Following that date, compulsory arbitration required the agreement of either the LO or the NAF after a breakdown of negoti-

ations, what might be called a voluntary arbitration system. The government too saw the wisdom of some relaxation and not only agreed to the end of compulsory arbitration but also expressed its view (in 1952) that concern about Norwegian prices relative to her major competitors did not seem likely to present major problems. Finally, the overall confidence that a less controlled and centralized system could nonetheless satisfy the needs of the unions and of the economy more generally was expressed in the abandonment in the 1952 contracts of provisions for automatic cost of living adjustments.

The actual decentralization achieved in this period, however, did not begin to approximate that suggested by the formal statements of intentions and policy provisions undertaken. The LO generally continued to indicate to its member unions a "framework" to which the individual unions should adhere in light of "national budget estimates" of tolerable wage increases. The government provided such estimates to the LO - although there was no formal structure of consultation - and remained deeply involved in the setting of prices in the agricultural sector. This was important because the unions were constantly concerned that their restraint would not be matched by behavior of others and that therefore they would lose ground relatively or would fail to maintain their real wages. Food prices were one of the major potential sources of such problems. Throughout the period, in fact, there was a repeated dialogue between the LO and the government: the latter would ask the unions to assure restraint in order to help control inflationary pressures and maintain the economy's international competitiveness, both of which would redound to the workers' favor; the unions would repeatedly stress to the government its responsibility to assure that such restraint would be exercised throughout the society and not just by the unionized work force.

Actual developments in wage negotiations and in the labor market more generally reflected the ambiguous and more weakly structured status of incomes policy in these years. There were no settlements which dramatically broke with guidelines set by the unions or the government, but these guidelines became increasingly complex and often reflected the anticipated pressures from rank and file unionists for better agreements. A number of other developments also reflect the increase in tension and uncertainty in wage setting in this period:

A. All contracts with the exception of that in 1956 were struck at the center, between LO and NAF. In 1956, however, LO refused to set concrete parameters on the size of wage increases and no agreement could be reached when central negotiations were attempted. Contracts were settled at the industry level. Furthermore, in the 1954 negotiations, the centralized agreement on wages and benefits reached between LO and NAF was deemed by many workers to have been inappropriate. More than one third of the workers voted against ratification and in five of the twenty-five unions a majority opposed it.

B. Reflecting this increased tension between the rank and file and the peak, the volume of strikes in 1956 was more than triple that of preceding years. Furthermore, in a number of the other contract years, the threat of strikes hung over negotiations and influenced the course of bargaining. The strike volume in 1961 was the second highest in the postwar period.

C. There were repeated attempts to find an appropriate balance between the stringency of cost of living provisions in contracts and contract length. In 1953, for instance, cost of living adjustments were not negotiated, but the contract had only a one year duration. In 1954, however, two year contracts were again introduced. At the same time, complex provisions were established for renegotiation of the contract during its term should cost of living exceed certain levels.

D. The concerns about the cost of living were based in reality in this period. On the one hand, with the world trade slump after the Korean War, Norway's balance of trade position suffered a significant deterioration, prompting the government to seek to use its influence to keep down wage settlements. In 1953, for instance, under government urging, the LO accepted a simple renewal of the 1952 contract without significant changes. On the other hand, rising prices outside the export sector, especially of food, repeatedly threatened to erode the value of workers' wages and undermine the conditions necessary for cooperatively based wage restraint. The government, therefore, made numerous interventions with agricultural producers to reduce the inflationary pressure from that sector, invoking its potential ability to fix prices should the specific situation be deemed to require it. In 1955 the government also undertook measures to reduce the volume of new capital expenditures in industry.

To summarize, Phase 2 was marked by growing tensions and increased fluctuations and readjustments in the system by which wages were regulated as a result of the (necessary) loosening of the strict regime of controls and institutions which had characterized Phase 1. Centralization, the susceptibility to mutual influence of the centralized associations of the principle economic sectors, the willingness of workers to accept openly restrained bargains and the widespread involvement of the government all remained, but there was more discord, restiveness and instability. Predictability about outcomes was reduced and so too was the seeming ability of the overall system to produce the desired macro-economic objectives.

Phase 3: New Institutions and a New Scope for Policy

Phase 2 closed with a resounding bang in 1961. The 1958 centralized settlement, undertaken during a relative economic slump which included the highest rate of postwar unemployment, and with relatively pessimistic economic

forecasts, was an extremely restrained one. For one thing, the LO accepted a three year contract rather than the by then "normal" two year one. In addition, while the wage gains in the first two years of the contract were reasonably good, the third year had no contractual raise scheduled. Contrary to predictions, however, the economy recovered very strongly and by the time the 1961 contract renewal came up, the workers and the unions were anxious for a significant "catch-up". The result was that LO called for a decentralized process of bargaining and the contracts which were reached, after considerable strike activity, were highly inflationary. The government then determined that it had to take a more active role in the wage determination process. It also undertook to establish a set of institutions which would enable it to do so, and which would create the best atmosphere for cooperation among the relevant actors.

Three institutions, established in this third phase and still in place are of particular importance. The first of these is the "Contact Group", created by the government in 1963. The Group is made up of representatives of all the major peak associations in the economy (LO, NAF, two major agricultural associations, the fishing association) and the government. It has two major explicit functions: 1) to act as a preparatory forum for wage and price discussions by providing for the exchange of information and the development of agreed upon estimates of the likely development of the economy; 2) to assure the maintenance of relative intersectoral parity of incomes, including the share of GNP going to capital and to labor. The Contact Group works on unanimity principles which virtually assure that all agreements will have no more than marginal effects on shares. In addition to these two functions, a third has assumed increasing importance in the last decade: provision of a forum within which agreements about wages can be coordinated with a broad range of other macroeconomic decisions not only about prices in other sectors but also about taxes and government benefits. I will discuss this development further in a moment.

The second important institutional development is the creation in 1965 of the "Technical Committee" which acts as a technical economic advisory subcommittee of the Contact Group. Its principle function is to provide the Group with sophisticated estimates of the impact on economic performance of different possible wage, price and subsidy settlements. The Committee's membership has come to include technical experts from the major interests, from the relevant government ministries, and from the financial sector.

The third major institutional innovation is the introduction of the "Aukrust Model" of the Norwegian economy as the basis upon which the Technical Committee reaches its estimates and transforms them into parameters which can be used in the negotiations within the Contact Group. The basic features of the Aukrust Model (and its successor, PRIM) are very similar to those used in the model employed in Swedish wage/price negotiations. Assuming the openness and export dependence of the Norwegian economy, the model divides the economy into two sectors, the "exposed" (that which is import-and export-competing) and the "sheltered". It is then argued that "given fixed exchange rates, the labor costs compatible with full employment and capital renewal depend on projected international prices and productivity in the exposed sectors. Wages established in the export sector are transmitted by labor market organizations to the sheltered sectors. Domestic prices follow wages in 'cost plus' pricing."[1]

Since the mid-1960s wage negotiations in Norway have been conducted through the use of these three institutional mechanisms. They have institutionalized and structured the somewhat more disorganized process which characterized the preceding phase. They have reinforced the centralized and

1. Donald Schwerin, "Norwegian and Danish Incomes Policies and European Monetary Integration", West European Politics (1981).

cooperative framework while remaining true to the rinciple that government should not directly control the outcomes of the collective bargaining process. Three exceptions to this general pattern, however, are worthy of note.

First, there has been one significant breakdown of the centralized system. The 1974 contracts, like those in 1961, were negotiated not at the central but at the individual union level; and, again as in 1961, they were more inflationary than most of the centrally-negotiated contracts had been. Equally as interesting, the explanation for this breakdown of the centralized system appears to have been the desire of the unions to "catch up". In 1974 this dynamic was particularly strong because, on the one hand, the 1972 contract had included relatively modest wage increases and, on the other hand, inflation was somewhat higher than anticipated, social security contributions had increased and there had been significant bracket creep for workers. The result was that as they entered the 1974 negotiations, workers had had three years of very low (and in 1972, negative) real wage growth despite the fact that aggregate economic growth had been sustained. What this case, when combined with the 1961 one, suggests is that the centralized and self - and mutually - regulated system of incomes policy is subject to breakdown from the union side when economic conditions are relatively expansive and workers' share of the expansion is deemed by the unions to be inadequate and a potential (or already expressed) source of internal dissent.

The second exception is of a different sort: here the issue is not of a formal breakdown of centralized bargaining but rather that the outcomes of that bargaining are inconsistent with the objectives (international competitiveness, full employment and control of inflation) of the incomes policy system. This occurred in the mid-1970's when the combination of the wage drift,

government subsidies to industry and government willingness to finance increases in pensions and in farm incomes led to significant overheating and, eventually, in September 1978, to a tight credit policy and a government imposed incomes and price freeze which lasted through December 1979. There are similarities in this outcome with that in Sweden in the same period. Like the Swedes, the Norwegian government was willing to finance current consumption with foreign-held debt. Furthermore, again as with the Swedish case, this represented a displacement of domestic pressures into foreign debt, as the government relaxed the disciplinary role which it must play in the Contact Group if agreements there are not to degenerate into a kind of "robbers coalition" agreement which breaks the public bank. One significant difference with the Swedish case, however, must be noted. The Norwegian government was particularly susceptible to this pressure, and particularly prone to cede to it, because of the expectation of major revenues from Norway's oil production. The situation in this period became particularly bad because not only did the government exceed the levels of expenditures dictated by its own forecasting methods, but the oil revenues fell short of what was anticipated. The stabilization measures undertaken in 1978 and 1979 did restore stability and lead to major improvements in Norway's international competitive position. As the most recent O.E.C.D. survey suggests, however, the system which worked well until the international economic crisis following 1974, has not worked well subsequently. Norway's trade off between employment and inflation, her international competitiveness and her rate of investment have remained good when compared with most of the other European economies, but the entire process of voluntary income regulation has not been restabilized and no effective mechanisms for integrating oil revenues into the overall framework of economic policy making have been developed.

The third significant exception is that compulsory arbitration has been resorted to two times since 1963. In both these cases it has been invoked by the LO after a failure to reach agreement with the NAF. It is probably significant, however, that both these instances occurred in the mid-1960's before the three institutional mechanisms discussed above were fully in place. Nonetheless, there is little question that recourse, and the potential for recourse, to compulsory arbitration has played a larger role in Norway than in other European countries.

In concluding this discussion of the third phase of postwar Norwegian incomes policy, one further extremely important development requires discussion. The period since 1963 has been marked by a tendency for the agreements reached in the Contact Group, and seconded and guaranteed by the government, to expand in scope. More and more policy issues have been drawn into the negotiations and balanced in order to meet the overall parameters of general macroeconomic performance. This tendency was most evident in the agreement of 1976. Under the highly active tutelage of the government which was seeking to promote incomes restraint, the 1976 agreement covered not only industrial wages but also taxes, salaries, pensions, food prices, child support payments, farm support prices and other lesser categories. Wage restraint was to be compensated by what can only be considered as side-payments in these other areas. The agreement was the outcome of bi-lateral bargaining between the government and the relevant associations, between the associations themselves, as well as multilateral negotiation. The agreement, like earlier ones was ratified both by workers and by Parliament. This form of "combined agreement" may now have become a norm in Norway. It seems to be a logical outgrowth of the structures of the incomes policy system, with their multi-lateral character, and of the need, in a situation of international economic stringency, to be particularly sensitive to wage and price movements which may damage competitiveness. It

also represents more a combination of policy elements which had been tried at various times in the past than the introduction of entirely new policy instruments. It remains unclear, however, whether such broad agreements can be effectively sustained and kept within the parameters necessary for Norway to attain her economic objectives.

3. Explanatory Factors

Incomes policy can be understood as a policy problem of collective behavior and public goods. At the simpliest level, workers are being asked to forego short-term benefits which they probably would be able to attain through militant pursuit of their interests in order to promote a medium - and longer-term public good: improved national economic performance. This public good, if achieved, would accrue to the worker whether or not he individually chose to cooperate by giving up his short-term benefits. Furthermore, the behavior of any individual worker can not affect the likelihood that the public good will be attained. Thus, if the worker is understood as a rational maximizer of his economic interests, he has no reason to cooperate in an incomes policy.

Of course, the individual worker does not stand alone in reality. It is the trade union which acts on his behalf, and it is the trade union leadership which, in the first instance, makes the decision whether to cooperate in a voluntary incomes policy. This does not, however, fully relieve the problem. On the one hand, the individual worker, asked by his union to make sacrifices for the public good, may protest, becoming a dissident within his union. The union is telling the worker that his sacrifices will promote not only the public good, but his medium and longer-term interest as well: that the economy will achieve better rates of growth and therefore lower rates of unemployment and better improvements in real wages. Nonetheless, this still does not resolve the problem for the worker can always think that he would do better if the union were more militant.

From the standpoint of the union leadership, therefore, acceding to voluntary incomes regulation always runs a real risk of internal dissent which might take various forms, ranging from insurgent challenges to union leadership to decentralized pressures for improvements in wages beyond those stipulated in the contract, leading to worker-pushed wage drift. (Such drift can also obviously arise from employer behavior, such as competition for labor, especially skilled labor).

Faced with this risk, why would the union leadership accede to voluntary wage regulation? On the one hand, it must believe that the benefits which would result from such regulation - or the damage which would result were a more militant strategy pursued - are sufficiently worthwhile to justify the risks incurred. This involves both some understanding of the prospects of the economy and the constraints within which it operates, and some calculation of the probability that if the union agrees to regulated wages, the promised benefits will actually result. On the other hand, the union leadership must have some sense that the dangers of internal dissent are manageable, at least in the time before the medium-term benefits of regulation begin to be felt by the workers.

On the basis of this understanding of incomes policy, one would expect it to be put in place and maintained with union cooperation when conditions both reduce the risks of internal dissent and increase the benefits which the union thinks which will result from regulation. The conditions which promote such a situation are both historical and structural - affecting the general context within which a decision about incomes policy is undertaken - and more short-term, affecting the immediate decisional calculus of both unions and the government. Furthermore, these conditions are:

A. Historical/Cultural - To what extent do the national traditions of relationships between unions, employers and the government, and between the government and other key economic sectors, promote cooperative rather than conflictual postures? To what extent does the historical and cultural tradition, and its institutional expressions, promote government intervention (beyond Keynesian demand management) for the purposes of achieving macro-economic objectives?

B. Political - To what extent does the relationship of the government to key economic actors, particularly the trade unions, promote a cooperative relationship in the formulation and implementation of mutually agreed upon objectives? To what extent is the government able to assure that the commitments it takes as part of an incomes policy will be adhered to? To what extent can and does the government guarantee that other actors in an agreement will adhere to their commitments? To what extent are there institutional mechanisms in place which promote discussion and cooperation between government and the critical economic actors? To what degree can and does the government promise to compensate actors for at least some of the losses they may suffer by cooperating. To the extent that the government acts as a promoter, guarantor, and compensator in the process by which incomes policy is made, the likelihood of such a policy is increased.

C. To what extent are the critical economic actors organized in a manner which will promote their ability to undertake and implement centralized decisions and to assure that their sub-units will also adhere to such decisions? To what extent are the centralized organizations, if they exist, expressions of the entire sector which they claim to represent?

D. Interorganizational - To what degree are there channels and institutions

in place for discussion between the associations representing the major economic interests?

E. Economic - To what extent does the overall economic position of the economy encourage wage regulation by increasing the costs to overall economic performance of failures to regulate wages? To what extent does the immediate economic situation at the time that wage regulation is being considered promote a strong perception of the advantages of such regulation?

These factors affect the likelihood of voluntary incomes policy in any of the advanced industrial capitalist democracies. To the extent that only some conditions conducive to such a policy are present, the probability of such a policy being undertaken and maintained is reduced. Furthermore, some of these factors play a more important role than others. Considerable centralization of the critical economic sectors, a high reliability that the government will be able to carry through its role in such a policy and a clear and present advantage to regulating wages (and cost of not doing so) seem the most critical. They may be able to override historical/cultural and institutional conditions which would tend to reduce the likelihood of voluntary incomes policy. In the Norwegian case, however, such considerations of relative importance are less relevant, for in Norway almost all the factors consistently work in favor of incomes policy. Let me cite a few examples.

A. Historical/Cultural -

1) Norwegian incomes policy began after the war, but there were a number of developments prior to that period which were conducive to such a policy. State intervention in the economy, and especially in industrial relations had a history going back to 1911. In 1915 there had already been legislation authorizing compulsory mediation, and legislation for compulsory arbitration was put in place in 1921.

2) The LO had originally been a highly militant union with an intense class

conflict perspective. Strike volume in Norway in the interwar period was the highest in Europe. The Labor Party, to which the LO was closely tied, had also been a highly militant, class conflict-oriented Marxist party in the first part of the century. In the early 1930's, however, both the union and the party undertook a major internal strategic revision which led to the adoption of a growth-oriented, reformist stance, and it was this stance which allowed the Labor Party to come to government in the mid-1930's in alliance with the Agrarian Party. This shift, and the success it brought, made the LO and the Labor Party prone to accept the notion of incomes policy, especially if the Labor Party was in government, as was the case after World War II. Ironically, however, the radical tradition within the labor movement also left behind some important traces which were conducive to an incomes policy: a close linkage between the union movement and the Labor Party, a highly centralized union movement and a tradition of class solidarity among Norwegian workers.

3) The third major historical legacy was the tradition of cooperation between unions and employers which began to develop in Norway in the late-1930's and which was continued and reinforced during the period of exile. Joint labor-management planning for the postwar economy began in exile before the end of the war. Many of the plans which were subsequently implemented by the post-war government were devised during this period. The Council for Economic Cooperation which brought together all the major sectoral associations in Norway immediately after the war and which helped to coordinate the postwar strategy was the most important institutional expression of the cooperative tradition which had developed. This Council only fell apart in 1954 when the employers withdrew.

From even this brief survey, then, it is clear that the historical traditions in Norway were conducive to incomes policy.

B. Political

Political conditions in postwar Norway have been particularly favorable to the development of incomes policy.

1) The predominant control of government by the Labor Party has particular importance. Until the recent elections, Labor controlled government for all but five years (1966-1971, and a brief interval in 1973) of the postwar period. This control probably lost some of its importance as the institutions and practices of incomes policy became established; there was not, for instance, a significant withdrawal from these institutions when Labor was out in the late 1960's. There is little question, however, that Labor control of government played an important role at the inception of the system and that it probably continued to have some effect on the stability of the system throughout. This role was of three kinds: 1) the Labor Party could call on the unions to undertake policies which would contribute to its electoral standing. The unions, given the historical linkages between them and Labor, were strongly inclined to be susceptible to such appeals; 2) the presence of Labor governments helped to guarantee to the unions that government action would sustain the agreements made; 3) assured control of government by a pro-labor party probably served to reduce the likelihood that employers would adopt a hostile and militant stance toward the unions. It thus fostered union-management cooperation.

2) A further political condition of major significance for postwar Norwegian incomes policy has been the wide range of policy instruments available to the government to exercise influence over the sectoral actors. These instruments have included not just the legislation with regard to mediation and arbitration, but also that permitting price control when it is deemed economically necessary. We have seen that both these sets of instruments have been used

repeatedly by the government, often in cooperation with the sectoral associations, to maintain stability in the incomes policy system. Furthermore, they have strengthened the government's bargaining position as it negotiated with these associations and sought to promote agreements between them consistent with national economic objectives.

3) The third major political condition promoting incomes policy has been the willingness of government to use a variety of the policy instruments under its control (taxes, subsidies, pensions, etc.) to foster agreements with respect to wages. As we have seen, this has become an increasingly important part of the overall incomes policy system in the last decade. That the government has done so, and has been able to assure that the necessary Parliamentary consent would be given to these agreements reached outside the legislative forum, has made the maintenance of the incomes policy system more likely. It is also the case, however, that the facility with which the government could resort to using public policy to compensate sectoral actors may have contributed to the overstimulative policies which were undertaken in the mid-1970's.

4) The final political factor of significance has been the willingness of the government to put in place and to support institutions intended to foster cooperation between unions, employers and the associations in the other important sectors. This was most evident in the 1963-1966 period when the government, displeased with the outcome of the decentralized bargaining in 1961 actively undertook to create the Contact Group, the Technical Committee and to provide the expertise necessary to make the Aukrust Model an effective instrument of public policy.

From the preceding, it is clear that, in Norway, the government has been both willing and able to act as a promoter, guarantor and potential and actual compensator in the incomes policy system. In doing so it has both increased the incentives and reduced the risks attached to that system for the associations

of the major economic sectors, above all for the unions and employers.

C. Organizational

The two major organizational factors affecting the likelihood of implementing and maintaining a successful voluntary incomes policy are the extent to which the major economic associations are highly centralized and have a wide coverage in the sectors they organize. In both respects, conditions in Norway are highly favorable.

Looking first at the union movement, it has already been noted that the LO is highly centralized and has wide coverage. There are thirty-seven* unions in Norway and all but the public service white collar workers are negotiated for by LO. In contrast to Sweden, there is no separate union for private sector white collar workers. Unlike a number of other European countries, furthermore, there are no major political divisions within LO. Unionization is also very high in Norway. Sixty-seven percent of non-agricultural wage and salary workers were unionized in 1970 and it appears almost certain that the number has increased subsequently. The only country in Europe with higher rates of unionization is Sweden.

The centralized power of LO is not only a function of the relatively small number of unions in the country and of the fact that they all belong to the federation. The LO also has a number of mechanisms which increase its sway with its affiliates. First, the central organization controls the strike funds available to the member unions and thus has the potential to sanction a strike with which it does not agree by withholding such funds. Second, given the structure of the institutions through which incomes policy decisions are reached, the LO has a virtual monopoly of technical expertise with regard to the constraints operating on the general economy. This places it in an advantageous bargaining position with respect to its individual member unions.

* The four largest have 47% of the membership in LO; the ten largest have 74%.

By themselves, it seems unlikely that the two preceding factors are sufficient to explain the extent to which the LO has been able to exercise centralized control and still largely avoid major outbreaks of internal dissent even as it was undertaking significant regulation of wages. Were internal discontent sufficiently strong, it would almost certainly override the funding and informational power of the peak of the LO. The federation has also had three more subtle but important sources of influence. The first of these is the tradition of class solidarity. The LO has at a number of points explicitly called on this tradition to justify contracts which, while being quite restrained in their overall wage increases, were supposed to benefit the weaker, less skilled sectors of the work force. The tradition of solidarity has also affirmed the role of the central labor organization as the appropriate instrument to advance the overall interests of Norwegian workers.

A second source of less visible power for the LO center has been the experience with wage regulation in the postwar years. From the standpoint of the union movement as a whole and the individual worker, that experience has been highly positive. Real wages have steadily risen and Norway has maintained among the lowest unemployment rates in all of Europe, even in the years since 1974. While it can not, of course, be proven that other methods of setting wages might not have done better for the workers and while they might have wanted the unions to press wage demands harder in any specific contract negotiation, the overall record is such that the LO has developed considerable authority when it seeks wage restraint from its individual unions and from workers.

The third and final source of centralized power of this sort arises out of the procedures by which the contracts themselves are arrived at. As has been suggested earlier, the contracts reached at the peak must be ratified

by LO members. Ratification is granted by a majority vote of all members, not on a union by union basis. The importance of the ratification process is, on the one hand, that it legitimates and enhances the development of authority of the peak of the LO and its bargaining procedures: contracts are accepted, not imposed. On the other hand, the ratification requirement has of necessity made the LO peak sensitive to the humor of its members. This, in turn, has reduced the likelihood of severe friction within the union movement and has instead encouraged the development of a cooperative relationship between the different levels within it. Taken together with the other factors, the procedures for ratification have reinforced the ability of the peak of the LO to exercise centralized control.

Centralization has also operated among the employers. The NAF has been able to speak and act with credibility on behalf of the firms which it organizes and on behalf of which it bargains. There is less information available on why this has been so, but at least two reasons can be suggested. On the one hand, the overall system of incomes policy has generally operated in their interests. Growth has been good and investment rates have been high by international standards. On the other hand, the system has also provided Norwegian employers with at least one critical resource: predictability about the likely movement of the major economic factors affecting their production decisions. Such predictability has probably been worth whatever loss in autonomy which employers have felt due to the centralized bargaining procedures. In addition to these factors, it should also be noted that in a society as small as Norway, communication among employers is easy, thus making coordination and cooperation easier.

From the preceding discussion, it is apparent that conditions in Norway have been almost perfectly suited to centralized bargaining among the major economic associations. It is worth underlining, however, that this has

been a function not just of organizational rules and traditions but also of the experience with the incomes policy system itself. A system which initially was highly controlled - recall the rules of the first postwar phase - has "worked", and this has meant that it has become legitimated, that the central organizations have gained authority and that the need for formal rules guaranteeing centralized bargaining has lessened. This should not, however, suggest that the centralized organizations, particularly the LO, are not subject to pressures from their "periphery" nor that breakdowns of centralized control have become impossible.

D. Interorganizational

Little need be said on the role played by institutions for contact between the major economic associations. We have already underlined the importance assumed by the Contact Group and its Technical Committee since the mid-1960's. These forums, initiated by government action, have provided the opportunity for regular discussion between all the major economic groups and the government and have allowed those discussions to proceed on the basis of detailed economic information and guidelines. The potentially negative side of this situation should also be noted, however. The very broad composition of these institutions has encouraged expansion of the scope of the bargains struck within them in an effort to assure that all groups' interests are served. In a situation of economic stringency like that since 1974, however, this process has the potential to lead to over-stimulative outcomes unless the government, acting as a referee, is able to impose appropriate parameters and gain the agreement of the actors. The character and composition of the Contact Group make maintenance of aggregate economic shares of all the major interests a virtual necessity. In the years of easy growth, this generally proved possible even while the desired macro-economic objectives were promoted. The experience since 1974, however, suggests that it may no longer be as likely.

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E. Economic

We have already indicated at length the way that Norway's position in the international economy has been conducive to incomes policy. All sectors of society have been keenly aware since the war that the overall success of the economy in the medium- and long-run would be dependent on the ability to maintain a high level of exports and to develop effective import-substituting industries. These were among the most important objectives pursued in the first postwar phase of postwar incomes policy, and they have remained so to the present day. In pursuit of these objectives, furthermore, it has been recognized that wages would have to be kept at levels which would allow Norwegian goods to compete effectively (especially if high levels of employment were to be sustained) and that investment levels would have to be high. The Aukrust and Prim models which have been used since the 1960's to set the parameters for negotiations have incorporated these concerns.

There are, of course, a number of economies which face problems similar to that of Norway's. It is noteworthy that most of these have systems for the promotion of incomes policy in place (eg., Austria, the Netherlands, Sweden). The dimensions of the problem in Norway, however, can be indicated by a few statistical data. Exports of goods and services including shipping constitute 43% of Norway's Gross Domestic Product. Approximately 40% of these exports are in semi-processed goods and thus are very sensitive to foreign business cycles. More generally, it can be said that Norway, both because of the size of its economy and the kinds of goods it exports is a "price taker" in the international economy. This fact is dramatically brought out in a recent O.E.C.D. Survey(1979) which estimated that "...if export prices rise by 1% [in Norway] , export volumes may fall by 0.9%". With export price elasticity of this sort, it is little surprise that Norwegian unions and employers have

been willing, given the appropriate conditions discussed above, to seek to adjust their behavior to assure the best possible export performance.

4. Performance and Problems: Some Evaluations

In its 1981 Survey of the Norwegian economy, the O.E.C.D. noted that incomes policy in Norway "operated with a large measure of success over a prolonged period up to the early 1970's". There is considerable evidence in support of this judgement. Norway has had sustained growth in Gross Domestic Product; its unemployment rate has consistently been among the lowest in Europe, hovering around one percent; its strike rate has been, with the exception of a couple of years, been extremely low, both in comparison with other European countries and with the record of strike activity in the pre-World War II period in Norway; it has been able to maintain a significant share of export markets for its goods; its rate of inflation was generally comparable to that in the rest of Europe, although for some periods slightly higher.

Even in the last decade, Norwegian performance, by comparative standards has been quite good. Her average change in "real" Gross Domestic Product in the period 1977-1980 was 4.1 percent, one of the highest among the advanced industrial democracies; this represented a rate only 0.6% lower than the average rate in the period from 1960 to 1963, one of the smallest declines among these same countries. Similarly, Norwegian unemployment increased by only 0.2% between the period 1970-1973 and the period 1977-1980, a record matched by very few other European and non-European advanced industrial nations: eg., similar figures for the U.S.A. are 1.2%; for the Federal Republic of Germany, 2.7%; for Austria,0.5%; for Japan, 0.8%. Finally, if we look at inflation, Norwegian consumer prices rose by 8.2% on average from 1977-1980. This compared favorably with a large number of the advanced industrial democracies, although it was higher than the rates in Japan (5.9%), the Netherlands (6.3%)

Austria (4.8%) and Germany (4.0%), to cite the most relevant examples. Even in this regard, however, it is worthy of note that this rate of inflation did not represent a major acceleration over the rate earlier in the decade.

The criteria by which success is to be measured, however, are always open to question. We have already suggested that if the sucess of the Norwegian incomes policy system is to be judged in terms of its ability to provide predictability and stable export performance, the last decade has not been highly successful. Some wage settlements (eg., 1974) have been too large in light of the overall economic context, a wage and price freeze has had to be introduced, and Norway's export record has been unstable. As an example of this last point, it has been estimated by O.E.C.D. that while Norway's export markets expanded by 35% between 1972 and 1977, Norway's volume of exports grew by only 2.5%; approximately 60% of the loss Norway suffered was due to a deterioration of the price/cost competitiveness of Norway's products (Survey, 1979). Other comparisons and criteria (for instance, one which would estimate how good Norwegian performance could have been given its oil revenues) would also probably lead to less favorable judgements.

In this light, it is probably worthwile briefly to indicate some of the persistent and present-day problems faced by the Norwegian incomes policy system.

A. Wage drift - It has been consistently argued by critics of incomes policy that it simply promotes wage drift. There is no question that throughout the postwar period there has been such drift in Norway. It also appears to be the case that such drift varies inversely with the size of the contractual increase which has been granted, and varies directly with the overall level of economic activity (O.E.C.D. Survey, 1975). Nonetheless, even if there is no question that wage drift represents a problem for an incomes policy system, especially one as centralized as that in Norway, two further points should

be noted. First, some wage drift, especially if its size is relatively predictable is both tolerable and useful under many circumstances in an incomes policy system such as that in Norway. Its utility derives from the fact that it can both act as a safety valve at the firm and plant level for workers who feel particularly damaged by the centralized agreement and provide some flexibility in the distribution of (especially skilled) labor to adjust to unexpected developments. Of course, both these advantages only accrue to the extent that the wage drift is controlled and does not represent an overall rejection of the centralized agreement. It is noteworthy that the Norwegian government only devoted concentrated attention to the wage drift problem following the problems of the 1974-1977 period.The second relevant point with respect to wage drift is that its severity muct be judged (however difficult this may be) in the context of what wages levels and other economic and political consequences would have resulted had no incomes policy system been in place.

B. Organizational dissent and breakdown - This is always a problem in any incomes policy system as we have indicated. There have been some breakdowns, leading to decentralized contracts in the postwar Norwegian history and there have been frequent cases when the union leadership has had to adjust its position to meet the demands of its constituents. Nonetheless, especially since the establishment of the institutions which have characterized the third phase, the likelihood of such breakdowns appears to have decreased. Real questions can be raised, however, about whether this will be the case if there are repeated contracts arrived at under conditions of severe economic stringency.

C. "Robbers' Coalition" - Again, this is a problem which has already been discussed. It is worth underlining, however, that the Norwegian system as it currently functions is particularly prone to attempts by the economic

members of the Contact Committee to reach agreements which maintain their shares and which improve the situations of their members relative to the preceding years but which have the effects of breaking through the parameters set by the economic model thus damaging economic performance. This danger becomes particularly severe in a situation of economic stringency like that of most of the last decade, and the problems experienced by Norway in these years are probably related to it. What should be stressed, however, is that the fundamental responsibility for avoiding this danger lies with the government. It has the task of "holding the line", of representing the medium-term public interest. As in so much of the economic discussion in recent years in the advanced capitalist democracies, therefore, attention comes once again to focus not on economic variables but political ones. In Norway, however, the system of incomes policy seems to provide the government with effective instruments to promote high levels of economic performance which can maintain both growth and full employment without excessively high rates of inflation.

Conclusions: The Relevance of the Norwegian Experience

On the basis of the analysis pursued in the preceding pages, it seems rather clear that it would be extremely difficult to create the conditions in the United States for an incomes policy system like that in Norway. Almost none of the factors discussed in the section on explanations (3) are present in this country, and this is the case for reasons which are deeply rooted in U.S. economic and political history. It may well be wothwile, however, to examine to what extent the experiences of Norway and the other countries which have consistently employed incomes policies in the postwar period can be helpful in thinking about what might be done in the U.S. economy to attain improved performance without the severe economic and human costs which are attached to the present economic strategy and to that which has been pursued in recent years. Certainly there is nothing in the Norwegian experience and that of the other countries which have operated with a stable incomes policy system to suggest a fundamental contradiction between such a system and good economic performance or democratic politics.

Representative REUSS. Mr. Martin, please proceed.

STATEMENT OF ANDREW MARTIN, RESEARCH ASSOCIATE, CENTER FOR POLICY ALTERNATIVES, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS., AND RESEARCH ASSOCIATE, HARVARD UNIVERSITY CENTER FOR EUROPEAN STUDIES

Mr. MARTIN. Thank you, Mr. Chairman. My name is Andrew Martin and I'm from MIT's Center for Policy Alternatives. I will briefly summarize the main points in my prepared statement and try to gear my remarks to the general questions that you raised, trying to use the Swedish case insofar as possible to illustrate certain general points I want to make.

Sweden is a country where you would expect to find an incomes policy. It's a small, open economy and very dependent on and vulnerable to international economic trends, as Mr. Kouri has pointed out.

In addition, it also has a lot of the organizational, institutional and political conditions which, from a comparative point of view, suggests that it has favorable conditions for an incomes policy.

This has to do with the highly centralized organizations of employers and unions that cover a very large portion of the labor force. These are institutional conditions that contrast very sharply with those in the United States, just as also the basic character of the small open economy contrasts very sharply with the United States.

Whether these very large contrasts rule out the possibility of an incomes policy in the United States or not, I'm not sure, and I'd like to come back to that issue later on.

My general point is that even under what appear to be quite favorable conditions for an incomes policy and which create a strong incentive to having an incomes policy—conditions which are characteristic of small economies—even under those conditions, it proves to be very difficult to operate an incomes policy which works when it really has to work. When, as Mr. Kouri described the situation prior to the 1970's, when international prices were stable, incomes policies worked very well. When international prices became very unstable, then incomes policies didn't work very well. It's almost to say that incomes policies work well when you don't need them and they don't work very well when you do need them. While, this is something of an exaggeration, I want to try to underline this point by some discussion of the Swedish case.

Having said that the institutional and economic conditions appear to be favorable for incomes policy in Sweden, Sweden nevertheless has not had an incomes policy in the usual sense. That is, there's no direct intervention by the government in wage determination through compulsory regulations or negotiated agreements between the government, unions and employers of the kind that have occurred in a regular way in Norway and, as I understand it, have been a frequent feature of the Finnish situation.

However, it is true that in Sweden collective bargaining is organized in such a way as to provide something like the equivalent of an incomes policy. The major organizations—employers and

unions, particularly the two biggest ones, the central organization of private sector employers and the largest union organization, the LO, for blue-collar workers, have ever since 1956, engaged in central negotiations which set the overall rate and pattern of wage changes for periods varying from 1 to 3 years. This has been a regular part of the Swedish wage-determination system.

Moreover, when these organizations make the central agreements, they recognize explicitly the implications of wage growth for the national economy and particularly the implications for external equilibrium which is so sensitive for an economy like Sweden's. In addition, they also largely agree on how to determine what those implications are, what the requirements of external equilibrium are, and that is by reference to the so-called Scandinavian model of inflation in an open economy mentioned by Mr. Kouri.

There's a wide degree of agreement, you might say, on the basic notion of how the economy works and why wages make a difference, to what extent they make a difference, and what are the other factors that are very important, including productivity and international prices.

Further, the government, as well as the negotiating organizations, does take explicit account of what's going on in the relationship between government policies and wage agreements so that there is a kind of implicit incomes policy which is privately administered but which is recognized both by the government and the private parties in the negotiations as having very important consequences for the shape of the economy.

So you might argue that while you can distinguish Swedish incomes policy from the more formal incomes policies in Finland and Norway, this may be a distinction without a difference.

Well, how effective has this implicit incomes policy been? Now some of my colleagues are very impatient with me for this, but I have to say that there's no unequivocal answer to that question.

Essentially, I think the reason is it's really not possible to evaluate the effectiveness of the Swedish central negotiation system apart from the economic environment in which it operates and the effects of government economic policy on it. In this, I think the argument is roughly parallel to that which Mr. Kouri made. Again, I would like to sort of exaggerate and characterize the point that I think was implicit in his argument, which is that given inflation in the world economy, not much can be done with respect to domestic inflation by a small open economy other than regulation of the exchange rate.

Does this leave anything to be done by other policies, macroeconomic policies and incomes policies? I think, yes, there is something to be done, and that is to try to prevent domestic actions by the Government in macroeconomic policy, for example, and by pricemakers—unions, employers, firms—to prevent actions by these actors from disturbing an equilibrium level of prices and wages within the framework of the room for maneuver that a government has in using exchange rate policy.

While it has frequently been argued in Scandinavia that revaluation is an important technique for shielding the economy from the inflow of world inflationary price rises—and, of course, in a much

larger and important economy, Germany—this strategy has been followed in much of the postwar period and in a way was followed again just very recently, still there are limits in the extent to which a government can utilize a flexible exchange rate policy.

I won't say anything about the arguments against doing so in general because I'm not sure they're convincing. But under the particular conditions prevailing last year, it was argued that once again Sweden should have revalued in order to shield the economy from the new surge of price increases in 1979. It was not done, and one of the arguments for not doing it was that Sweden already had a very high balance of payments deficit and a high degree of foreign indebtedness, so that a revaluation simply would not have been credible in the international money markets, eliminating that as a policy option.

Under those circumstances, it becomes perhaps all the more important to try to use whatever levers are available within the economy, such as macroeconomic policy and incomes policy, to try to cushion the domestic impact of increasing international prices.

My general argument would then be that incomes policy can be a useful supplement to other policies but can't substitute for them or make up for the deficiencies in other policies. If other policies move in the direction of wage and price stability, then an incomes policy might reasonably be expected to inhibit the development of autonomous wage raise or wage-price spiral, but I don't think it can be expected to do so in the face of economic policies or economic forces beyond the control of any policies which work in the opposite direction.

An incomes policy under these conditions, I would argue, is bound to break down, most likely to be followed by a wage explosion, and this has certainly been amply illustrated in the Swedish case.

During 1975–76, there was a wage explosion which contributed to severe economic crisis from which Sweden has yet to recover. This is the most conspicuous failure of the centralized negotiation system to perform the function of an incomes policy.

However, the government's management of aggregate demand, its exchange rate policy, and its negotiations with its own employees, amplified the impact of the powerful destabilizing forces in the international economy, reinforcing the pressures for large wage increases and aggravating their effects.

I would argue in this case that there was a margin for maneuver within which incomes policy or the central negotiations system might have been able to avoid aggravating the impact of international price movements but that the government's policies were essentially perverse with respect to that and intensified the impact of the international forces rather than dampening them. Under those circumstances, it was virtually inevitable that there should be a wage-price explosion which in turn had the kind of consequences that Mr. Kouri points out in terms of squeezing profits in the international export sector, squeezing profits and investment, and leading to stagnation.

There are a number of cases in which large wage increases threw the economy off the track in Sweden and in which unions and employers subsequently negotiated moderate increases aimed at get-

ting the economy back on the track. This is a kind of example of an incomes policy which helps to repair the damage. This may be reasonably analogous to the kind of situation you hypothesized for us today, or you have identified for us, in the United States today, where you have the aftermath of an economic crisis, a recession, and you're talking about trying to restore the economy, getting it back on track by an incomes policy among other things, which tries to avoid overheating the economy as the expansion goes on.

Yet, at least in the Scandinavian case or in the Swedish case, under conditions like this, where you have the threat of unemployment, where the labor market is not tight, where people have a high degree of consciousness of really serious economic difficulties—under those conditions, it's not very difficult, at least in Sweden, to get unions to agree to a high degree of wage restraint. And as I have suggested in my written testimony, the most conspicuous success of the central negotiation system in doing so in Sweden was the agreement for 1978–79 which contributed to one of the rare instances of a successful devaluation—a devaluation in 1977 whose effect on relative costs was reinforced by a wage agreement in which unions in effect agreed to take a cut in real wages, helping to absorb the redistribution of income to the OPEC countries.

Yet by 1979, inflationary pressures were building up again and government policy again contributed in very important ways to that. Under those conditions, that's precisely the moment at which you look for government policy, plus incomes policy, which would make it possible to sustain the expansion—that's the moment where you hope it's going to work and make it possible for the expansion to go on.

Well, it was precisely at this moment that macroeconomic policy failed to meet the conditions by being highly expansive at a point when the economy was already subject to expansive forces, and under those conditions, in turn, the central negotiation system proved unable to contribute to the preservation of the expansion. In effect, I'm arguing that it proved unable to withstand the shock imposed upon it by government's macroeconomic policy.

What happened, of course, was a major breakdown in the central negotiation system, a massive strike, the largest strike in Sweden's industrial relations history since 1909. My conclusion from all this is whatever potential the Swedish central negotiation system may have for performing the function of an incomes policy, government economic policies have not created the conditions under which that potential could be fully realized. This makes it really very hard to tell what that potential was.

In conclusion, I want to stress some features of the system which do limit its potential. One is the fact that there are separate negotiating bodies of blue- and white- collar workers and also private and public sector employers. There isn't a single comprehensive negotiating procedure in which an overall settlement is hammered out. Instead, there are separate negotiations in which groups with partially conflicting interests pursue their interests without having to confront each other. So all the institutional features or conditions for a successful incomes policy are not present in Sweden.

Another is the fact that the central organizations don't have enough control over actual wage formation at the workplace to really determine what the wage growth shall be. Thus, wage drift—that is to say, wage changes that are not provided for in wage contracts—has tended to run at about the same level as negotiated increases over the postwar period in Sweden. This, of course, is not that different from the Norwegian situation. All systems in which there's a high degree of centralized collective wage bargaining are characterized by wage drift reflecting the fact that there's a lot of decentralized bargaining that goes on and that market forces will assert themselves. This is recognized and is not thought to be a severe obstacle to arriving at national level wage agreements that do have a significant impact.

The point is that wage drift tends to transmit the effects of inflationary forces beyond the control of the wage management system onto the wage determination system. This undermines any attempts to restrain wages and prices if economic policies and international forces generate too strong pressures on the wage determination system.

What are the implications for the United States? I would argue that even though there's some ambiguity about the effectiveness, and I'm rather skeptical about how much you can expect from an incomes policy, I think the Scandinavian experience shows that under appropriate policy conditions there is a lot to be gained from an incomes policy. But my real doubts have to do with whether an incomes policy can help in the United States under present conditions.

I don't mean so much economic conditions as political conditions. Certainly it's a good time from an economic point of view to try to institute an incomes policy, to try to preserve the expansion which we hope lies ahead; but in order to get agreement on restraint among the various organizations in the economy, particularly the unions, to restraint, what's needed is the conviction not only that the Government will do what it says it's going to do but also that what the Government says it's going to do is equitable. It's very difficult to get agreement on equity in any economy, in any society, but I think it's probably impossible in the American context today to get agreement on equity, given the character of the present administration's economic policy.

An incomes policy, however, might be a useful part of a Democratic Party policy, a policy led by or designed to be led by a Democratic President in cooperation with a Democratic Party that has recovered its vision of a coalition for social progress of which the labor movement is an integral part.

Under those circumstances and in a future Democratic administration, in other words, it seems to me an incomes policy can contribute to improving the economic stability of the United States.

Representative REUSS. Thank you, Mr. Martin.

[The prepared statement of Mr. Martin follows:]

PREPARED STATEMENT OF ANDREW MARTIN

Mr. Chairman and Members of the Committee:

My name is Andrew Martin. I am a Research Associate of the Center for Policy Alternatives at Massachusetts Institute of Technology and also a Research Associate of the Center for European Studies at Harvard University. I am currently engaged in research on technological research and development policy in Sweden. Much of my recent research has been on various other aspects of economic and industrial policy in that country. My statement today is based on research for a study entitled, "Distributive Conflict, Inflation and Investment: The Swedish Case," to be published in Leon N. Lindberg and Charles S. Maier, eds., THE POLITICS AND SOCIOLOGY OF INFLATION (Washington, D.C.: The Brookings Institution, 1982). Full documentation of the discussion is presented in that study. An abridged version has been supplied for the record. Additional analysis of Sweden's economic problems is provided in a chapter prepared for the Joint Economic Committee Staff Study, "Monetary Policy, Selective Credit Policy, and Industrial Policy in France, Britain, West Germany and Sweden," June 26, 1981.

Sweden does not have an incomes policy in the usual sense of the term. That is, the government does not directly intervene in the wage determination process to limit wage growth, either by compulsion or negotiation. Indeed, it has long been an article of faith in Sweden that the government should not interfere with collective bargaining between employers and unions. This was breached only during the Second World War and in two years in the early postwar period. However, collective bargaining is organized in such a way that it often seems to perform the function of an incomes policy. This, in the case of a small, open economy like Sweden's, is primarily to gear wage growth to the requirements of external equilibrium.

I will briefly describe the collective bargaining system and then consider some of the issues involved in evaluating its effectiveness in performing this function. I will only explore the issues rather than venture a judgment because it is very difficult to disentangle the specific consequences of the collective bargaining system from all the other factors, including the whole array of government policies, shaping the economy's performance. In any case, it is impossible to do so within the limits of this statement.

I will try to raise the issues by describing what appears to have been the most conspicuous failure of the collective bargaining system to perform the functon of an incomes policy. That was a wage explosion during 1975-76. It contributed to an economic crisis from which Sweden has still not recovered. Should the crisis be attributed to characterisitics of the collective bargaining system, making it inevitably operate as it did? Or should the crisis be attributed to factors in the environment in which it operated, making it impossible to perform the function it would otherwise have been able to? Plausible arguments can be made for either position. Even if I will not pretend to settle the question, I think that considering the issues involved may shed some light on the conditions for an effective incomes policy and the difficulties in satisfying them.

I. The Industrial Relations System

A. The Organizations in the Labor Market

To all intents and purposes, union and employer organizations cover all employees in Sweden's labor force. Moreover, the organizations are highly centralized, giving the peak organizations a great deal of influence over their component organizations and members. These organizational characterisitics facilitate the regulation of wage growth through central negotiations among the peak organizations at national level.

On the other hand, there are multiple organizations that are to some extent in conflict with each other on both the employee and employer sides of the labor market. Moreover, the peak organizations, particularly of the unions, are not so centralized that they can keep wage growth within whatever limits they may deem desirable regardless of market forces. These organizational characteristics limit the extent to which wage growth can be regulated by national level central negotiations.

The employer side of the labor market is divided between the private and public sectors. The former is dominated by SAF, the Swedish Employers Confederation. It consists of 38 industry associations, whose member firms are "part owners" of the peak association. These firms employ slightly over half of all employees in the private sector. A little over three-quarters of all large firms--with 500 employees or more--belong to SAF, accounting for 14 percent of its member firms but 51 percent of the employees covered. Of the industrial associations, the engineering industry federation is the largest, covering over a quarter of SAF members' employees. Thus, SAF includes a substantial majority of the larger firms comprising the core of Swedish industry, as well as a significant minority of the smaller firms. In addition to SAF, there is

a number of much smaller employer associations in the private sector, in such branches as banking, insurance, forestry, the press, producers and consumers cooperatives.

There are separate negotiating bodies on the employer side of different parts of the public sector, accounting for a little over 30 percent of the labor force. A central government negotiating agency, SAV, covers roughly two fifths of public sector employees, including those in the school system although they are employed at the local government level. Those in state enterprises grouped in a state holding company, less than four percent of the sector total, are covered by a separate negotiating agency, SFO. The remainder, somewhat over half of public sector employees, are covered by negotiating bodies of the two levels of local government, the Association of Local Authorities and the Federation of County Councils.

The employee side of the labor market is organized by unions affiliated to three separate confederations. The largest as well as oldest is LO, the Swedish Confederation of Labor. Its 25 affiliated unions consist almost entirely of blue collar workers, accounting for roughly 95 percent of such workers and a little under a half of the labor force. The individual LO unions are organized almost entirely on an industrial basis. The metalworkers union, with a quarter of LO's membership, was the largest until 1978 when the local government workers union overtook it. Total LO membership has been growing at an annual rate of about three percent during the 1970s, somewhat faster than in the preceding decade.

The second largest confederation is TCO, the Central Organization of Salaried Employees. Its 24 affiliated unions consist of white collar workers, accounting for roughly three-quarters of them and about 22 percent of the labor force. A little over half of TCO membership is in the private sector, mostly in three unions. Of these, a union of clerical and technical workers in industry, with a quarter of TCO's membership, is the largest. Of the TCO unions in the public sector, the local government employees union, with a little over a tenth of the membership is the largest. There was little white collar unionization

until TCO's establishment in 1944 but it has grown rapidly since, fluctuating at around five percent in the 1970s.

The third and smallest confederation is SACO/SR. Resulting from a 1974 merger of two organizations of upper level white collar workers, predominantly in the public sector, it accounts for just under a twentieth of the labor force.

In addition to the occupational lines (increasingly blurred at the edges) along which the three confederations are distinguished, there are two other differences among them relevant to the possibilities for an incomes policy.

One is a political difference. The LO unions are closely linked to the Social Democratic party. Largest of Sweden's five parties, it governed the country, alone or in coalition, virtually without interruption from 1932 to 1976. The LO unions' support has been the single most important factor in the party's unparalleled continuity in office, supplying it with organizational and financial resources that have been decisive in mobilizing the electoral support of the LO union members comprising the party's core constituency.

Neither of the white collar confederations are linked to the Social Democratic party or to any other, however. A large minority of TCO members vote Social Democratic, as compared with a large majority of LO members, but the rest of TCO members' votes are scattered all the way across the political spectrum, while SACO/SR members' votes tend to be concentrated in the three non-socialist, or "bourgeois" parties, as they are called.

The other difference between the principal confederations concerns their roles in the collective bargaining system. While LO is a negotiating body TCO is not. The LO unions have authorized the confederation to negotiate central agreements with its employer counterparts ever since the first of the continuous series of central negotiations in 1956. TCO was authorized by its affiliates to do so only in 1956 and never again since. Instead, individual TCO unions first

negotiated separate agreements and then groups of them in the private and public sectors, respectively, gradually moved toward joint negotiations. Thus, a private sector white collar negotiating body, PTK, including several SACO/SR as well as TCO unions, was set up in 1973. Similar joint negotiating bodies, TCO-S and TCO-K, have been set up in the central and local government sectors, respectively, but without any SACO/SR participation. An important recent development is the establishment of joint negotiations among the four major public sector unions, two of which belong to LO and two of which belong to TCO, thus cutting across the two confederations along the public sector-private sector dividing line.

B. The Web of Rules

The interaction of LO and SAF has largely shaped the Swedish industrial relations system, into which the other organizations have been incorporated. The legal framework within which it has developed was, in turn, established in essentially three installments under different political conditions. Both the private and public rules in terms of which the industrial relations system is institutionalized affect the conditions for incomes policy.

Early in their history, LO and SAF attempted to arrive at a modus vivendi by which the unions' right to organize was recognized in return for recognition of management's right to manage. These lines of demarcation remained conflict-ridden, however, and SAF sought legal reinforcement of its claims. For a long time, this was blocked by an alliance of Social Democrats and liberals aimed at achieving universal suffrage. After that was achieved, a realignment of the liberals with the other bourgeois parties opened the way for legislation in 1928 that barred strikes over the terms of collective agreements while they were in effect, and required submission of disputes over those terms to a newly established labor court.

The force of law was turned in the other direction in 1936 when the Social Democrats enacted legislation guaranteeing the unions' right to organize, which broke down the barriers to white collar unionization. There was no further labor legislation until the first half of the 1970s

when the Social Democrats enacted a series of laws strengthening union power at the workplace. Among other things, the scope of collective bargaining was extended to all workplace issues, including those SAF had previously excluded on grounds of managerial prerogatives.

Between the second and third installments in the evolution of the legal framework, the rest of industrial relations practice was essentially governed by private rules jointly administered by LO and SAF in accordance with a so-called Basic Agreement negotiated in 1938. In the main, it specified procedures designed to maintain industrial peace without state intervention. This was now feared by SAF as a result of the Social Democrats' accession to power, and by LO in anticipation of the Social Democrats' eventual fall from power, which proved very much longer in coming. The Basic Agreement was followed by centralization of authority, particularly over strike decisions, within LO and its constituent unions, more closely approximating the centralization of authority long ago established in SAF.

In the decades since the Basic Agreement, Sweden has had one of the lowest strike rates in all the advanced capitalist industrial societies. But it should be stressed that this is to be explained not so much by the legal framework as the private government of industrial relations by LO and SAF. From the late 1920s when strikes during the life of contracts were made illegal until the mid-1930s, Sweden continued to have one of the highest strike rates. Thus, Sweden's more recent record of industrial peace reflects a change in strategies by the peak organizations of unions and employers that took place in the 1930s. Their joint regulation of industrial relations, associated with resistance to government intervention in collective bargaining, laid the basis for the particular Swedish form of "private incomes policy" that emerged in the 1950s.

C. The Origin of Centralized Negotiations

LO's opposition to government intervention in the wage determination process, even when the government was controlled by the Social Democrats, waa reinforced by its experience of postwar wage restraint under an

agreement with the government and employers during 1949 and 1950. LO issued a major policy statement in 1951 declaring control of inflation to be primarily the government's responsibility. Failure by the government to meet its responsibility, shifting it instead onto the unions by calling upon them to restrain wage growth, imposed on them severe risks to their organizational cohesion. Inflationary pressures assert themselves in the form of wage drift, from which different workers benefit in different degrees, creating tensions among different groups of workers and undermining the credibility of the unions' claims to represent the interests of all of them.

LO's statement did not reject any responsibility for economic stability whatsoever. It recognized, and welcomed, the fact that full employment strengthened union bargaining power, acknowledging at the same time that full exploitation of that power could add to inflationary pressures posing an eventual threat to full employment. It also emphasized that demand management alone was insufficient to curb inflation without sacrificing full employment. The principal way to supplement demand mangement was not by wage restraint, however, but by a combination of government and union policies designed to ercourage cost-reducing structural change in the economy.

The government was to combine a "general" fiscal policy that was a good deal tighter than the one it had pursued with a "selective" manpower policy on a scale vast enough to assure alternative jobs to all workers threatened by loss of jobs in the process of structural change. Structural change was, in turn, to be encouraged by a union wage policy of equal pay for equal work, regardless of employers' ability to pay, thereby forcing the contraction of inefficient, high-cost production and encouraging the expansion of efficient, low-cost production.

On the basis of such a "solidaristic wage policy," as LO called it, LO believed it could coordinate the wage bargaining of its constituent unions in such a way as to inhibit the kind of inter-union wage rivalry that could be an autonomous source of inflationary pressure. Provided the government carried out its primary responsibility for achieving non-inflationary full employment, by the prescribed combination of

general and selective measures, the unions could accordingly take on the additional responsibility of seeing that wage bargaining did not disrupt the non-inflationary full employment that had been achieved.

This is essentially the position that LO has held right down to the present, although it has undergone various modifications, particularly with respect to the conditions under which both the contraction of high-cost and expansion of low-cost production are regarded as acceptable. Somewhat less clearly, it is also the position that has come to be widely held among the white collar unions.

The important point for us is that both the original position and its subsequent modifications are predicated on what LO perceives to be the imperatives of organizational cohesion. Now as before, these imperatives set the limits on how far Swedish unions in general and LO in particular believe they can go in exercising wage restraint. As far as LO is concerned, it does not only attach such importance to organizational cohesion in the interest of conserving its bargaining power in the labor market. It also does so in the interest of preserving its capacity to mobilize support for the Social Democratic party in the political arena. From LO's standpoint, a Social Democratic government is a prerequisite for satisfying the unions'most important goal of maintaining full employment, and for curbing inflation in an acceptable way.

LO's early postwar policy position was increasingly approximated by the government from the late 1950s on. Moreover, LO did come to coordinate the wage bargaining of its affiliates beginning in 1956. However, it was not so much LO's wage policy that won its affiliates' consent to such coordination as pressures from SAF, which demanded central negotiations in an effort to dampen inter-union wage rivalry under the inflationary conditions in that year. SAF was able to force the situation not only because of the employers' common interest in doing so but also the greater degree of internal discipline SAF could impose. Although SAF did not intend to establish central negotiations as a permanent institution, that is how it turned out. Its main features and its role in the wage determination process are described in the next section.

D. Central Negotiations and the Wage Determination Process.

The results of the LO-SAF negotiations are embodied in so-called "frame agreements" which lay down the contours of wage changes in the forthcoming contract period, varying from one to three years. Formally, these are only recommendations which the parties to the agreements are committed to urge upon their affiliates. The latter, individual unions and industry associations--or companies in the case of the largest--negotiate the agreements that have the status of binding contracts under Swedish labor law.

In practice, these contracts follow the general provisions of the frame agreements, translating them into detailed terms for their respective negotiating jurisdictions. Local negotiations then complete the process of applying the terms to individual establishments and, in the larger ones, to specific groups of workers within them. Such negotiations do not simply follow up on national agreements, however. Especially in plants where earnings depend wholly or in part on piecework or other performance-based payment systems, wage bargaining tends to go on continuously, informally as well as formally.

The scope for interpretation and continuing local negotiations in this multi-level bargaining system means that the increases provided for in the central agreements cannot completely determine the actual growth of earnings. In fact, those increases have only accounted for roughly half of the actual growth of earnings, averaged over the period since 1956. The rest has taken the form of wage drift, defined as the difference between the actual increase in earnings and the "calculated effects of the central wage agreements on average earnings." Drift tends to vary with the tightness of labor markets and to some extent with profits; in other words, with the degree to which employers compete for labor. This, in turn, is obviously bound to affect the bargaining power of local union officials and even individual workers.

Thus, the central negotiations provide a mechanism that offers substantial possibilities for gearing wage growth to the requirements of economic stability. At the same time, the degree of decentralization

that remains in the wage determination system sets significant limits on those possibilities. Even if the central union and employer organizations can agree on what the requirements of economic stability are at a given point, they cannot confine wage growth to those requirements in the face of pressures for more rapid growth generated by market forces at the workplace. To the extent that the increases negotiated by the peak organizations fall short of that growth rate, the difference tends to be made up in the form of wage drift. The occurrence of some drift is regarded as unavoidable, reflecting necessary elements of flexibility and and providing a kind of safety valve. But the more drift there is, the more likely it is that the central organizations and their affiliates will be subjected to internal strains.

LO is particularly vulnerable to such strains since it is primarily among its industrial blue collar members that drift takes place. The fact that the incidence of drift tends to be uneven betweeen different unions and even within the same unions exacerbates the internal strains. At the same time, the concentration of drift within LO adds to the wage competition between unions in LO and the other confederations. This has become an increasingly serious problem, for while the central negotiation system was established at a time when the other confederations were small enough not to matter much, this has ceased to be the case as they have grown in size.

How earnings of LO private sector members are to be compared with earnings of TCO private sector members and of both LO and TCO public sector members is one of the main issues which has made it difficult to extend the coordination of wage bargaining across the whole labor market, as LO has long tried to do. This is tied up with the more basic issue of how much the earnings of those who get little or no drift should be increased to keep up with the earners of those who get a lot of drift. Such compensatory increases are called for by the logic of solidaristic wage policy, and LO has succeeded in negotiating earnings guarantee provisions designed to keep drift from opening up differentials that run counter to its wage policy. However, the guarantees act as an inflationary ratchet that transmits wage increases generated by tightness in some parts of the labor market across the rest of it. While this has

helped LO maintain its internal cohesion, PTK's efforts to win earnings guarantees that give its members 100 percent compensation for wage drift among LO members has proved to be a major stumbling block in efforts to establish joint negotiations by LO and PTK. Thus, the system of cent negotiations has not made it possible to overcome the inter-union wage rivalry stemming from the fundamental divisions in the structure of union organization.

Insofar as wage drift is a source of tension within and between union organizations that make them unable or unwilling to gear wage demands to the requirements of economic stability, the extent to which this is the case obviously depends on how much drift there is. This, in turn, depends on many things, but the overall level of drift ultimately depends on the degree of demand pressure there is. If that can be influenced at all, it is only by the government and not by the parties to collective bargaining. Macroeconomic policies capable of maintaining a degree of stability which an incomes policy can then be expected to reinforce are undoubtedly difficult to achieve in a small, open economy like Sweden's. In any case, macroeconomic policies that have aggravated rather than ameliorated the impact of external instability have certainly limited the effectiveness with which Sweden's system of central negotiations has been able to perform the function of an incomes policy.

In addition to the difficulties stemming from macroeconomic policy, another major source of difficulties in keeping wage growth consistent with economic stability has, of course, been the interaction of progressive income taxation and inflation. The resulting increase in the level of nominal wage increases needed to achieve increased real wages, or even prevent them from falling, has posed an increasingly salient issue in Sweden. In response, successive Swedish governments have repeatedly adjusted income tax scales to increase the after-tax value of given nominal wage increases, thereby trying to encourage lower settlements.

Such efforts have indeed brought Swedish governments very close to participating in the wage determination process in a way that amounts to an official incomes policy. There have been discussions between the government and unions in which there is an "exchange of views" about the

government's intended tax changes and the effects they could be expected to have on wage negotiations. However, none of these discussions have gotten to the point where the unions enter into an agreement with the government about the level of wage increases that will be set. Such discussions came closest to an incomes policy when the Social Democrats were still in office up to 1976. Disagreement between the unions and the four different "bourgeois" governments so far in office since then over the distributive profile of income tax changes have ruled out anything like that.

In the face of all these sources of difficulty, it would be surprising if Sweden's "private incomes policy" could have been very effective in achieving what it might reasonably have been expected to achieve. Nevertheless, the repeated efforts of the parties to the central negotiations to gear wage growth to the requirements of economic stability appear to have had some effectiveness until the mid-1970s, at least according to the criterion that had been widely accepted on both sides of the labor market. This criterion was embodied in the so-called EFO model, named after the employer and union economists who formulated it.

A version of what has been referred to as the Scandinavian model of inflation in a small, open economy, the EFO model specified a "main course" which wages had to follow in order to satisfy the requirements of external equilibrium. By and large, wage growth did apparently remain within the "scope" for increases specified by the EFO model over the succession of central agreements until the mid-1970s.

In this light, the wage explosion of 1975-76 looks like a sharp departure from the normal operation of the central negotiation system. Thus, the explanation for it would lie in the extraordinary combination of circumstances that surrounded it, including the extreme instability in Sweden's international economic environment and a cluster of policy "errors" that amplified the effects of that instability on wage determination. On the other hand, the wage explosion can also be seen as an extreme expression of a tendency to generate "wage disturbances" that was present in the system all along. Thus, it is only the exceptional

magnitude of the disturbance that is to be explained by the exceptional circumstances. The wage explosion scenario and these alternative interpretations of it are described in the next section.

II. Wage Determination, Economic Policy, and Sweden's Economic Problems

As a result of the wage agreement negotiated by LO and SAF for 1975-76, in combination with wage drift and payroll taxes, hourly wage costs in Swedish industry rose by 39 percent over the two-year period, the largest increase over a comparable period since the Korean War. This rise in costs contributed to a sharp decline in the international competitiveness of Swedish industry, accounting for about half of a 27 percent increase in the unit costs of Swedish exports relative to those of its competitors in the world market over the two years. Relatively low productivity growth accounted for another third, and an appreciation of the Swedish crown relative to currencies outside the "snake" (in which the crown was tied to the rising German mark) accounted for about a fifth.

Part of the sharp rise in costs was translated into a drastic fall in profits. Thus, capital's share of value added in the sector exposed to international competition--i.e., the tradables producing sector--fell from its long-time high of 31 percent in 1974, after averaging around 25 percent over the preceding 23 years, to a low of less than 7 percent in 1977. Profitability in industry displayed the sharpest drop "at least since the 1930s." The drop in profits would have been even greater if the rest of the rise in costs had not been passed on in prices. But that led to an estimated rise in the relative price of Swedish exports by nearly 14 percent over the two years. The result was a loss of market shares by Swedish exports over the same period estimated at 16 percent. Combined with a loss of shares in domestic markets, this produced a balance of payments deficit equivalent to 2.5 percent of GNP in 1977, and the sharpest declines in industrial production and investment, down by 3.4 and 17.1 percent, respectively, recorded in the postwar period.

This so-called "cost crisis" laid bare and rendered more intractable a "structural crisis." The competitiveness of several sectors had already been steadily eroded by changes in the international structure of

production. This was especially true of forestry and iron mining, and the industries built on the latter, steel and shipbuilding, which were of course in trouble all over the world. The extent of these sectors' vulnerability had been obscured by the worldwide inflationary boom in the early 1970s. When the boom collapsed following the oil crisis, the cost gap that opened up hit these sectors particularly hard. But while large portions of these sectors were evidently no longer viable, the collapse of profits and investment even in those sectors which were still internationally viable kept them from expanding to take up the slack. The interaction of the cost and structural elements in the crisis thus made it more serious than any confronting Swedish economic policy since the interwar Great Depression.

The dimensions of the crisis make it obvious that the 1975-76 central agreement fell drastically short of the requirements of external equilibrium. However, it directly followed a one-year agreement that just as certainly, if not as dramatically, subjected LO's internal cohesion to severe strains. In making the 1974 agreement, LO clearly settled for much lower increases than there was scope for. While the agreement provided for a 5.1 percent increase in average hourly earnings of adult industrial workers, wage drift added another 8.1 percent. The three percentage point excess of drift over contractual increases was greater than during the life of any preceding agreement, although it was less than in the second year of the 1969-70 agreement.

The high level of drift reflected the exceptionally high profits Swedish industry enjoyed as a result of the rapid acceleration of international prices in 1973 and 1974. The 31 percent share of capital in the tradables sectors' value-added was the highest since 1952. At the same time, drift was unevenly distributed, with the resource-based sectors benefiting especially from the world commodity price boom. The clearest demonstration of the consequences this had for organizational cohesion was a wave of wildcat strikes greater in some sectors than the more widely reported one in the winter of 1969-70 when, as just noted, drift exceeded contractual increases by even more. Hence, LO was under great pressure to make sure that the contractual increases in the next agreement would be so high that they would not be exceeded by wage drift .

While the imperatives of organizational cohesion made it inevitable that LO would press for large increases in the next agreement, this is not necessarily sufficient to account for a wage agreement that did as much damage as the one negotiated for the next two years. Things might well have turned out differently if it were not for a series of policy choices that can be recognized retrospectively as errors, based on what turned out to be misjudgments, which had nevertheless been widely shared.

First, the government reinforced the pressure for large increases by a highly expansionary macroeconomic policy. Sweden was one of the few countries that tried to offset the contractive effects of the sudden redistribution of income to the OPEC countries. In most of the other OECD countries, restrictive policies were adopted to keep the oil price increases from arresting the decline of inflation from its high levels in the earlier 1970s. In contrast, Sweden's Social Democratic government sought to "bridge over" the resulting recession in the OECD countries, stimulating demand to offset the fall in external demand. By the time it was recognized that the international recession proved deeper and longer than anticipated, however, it was too late to keep Sweden's costs from being thrust way ahead of the much slower growing costs in its trading partners.

The conditions for the wage explosion were also reinforced by other aspects of policy. For example, the government pursued a "perverse" exchange rate policy that magnified the impact of sharply rising international prices. That impact might well have been blunted, particularly in the sectors where it produced the greatest and most disruptive wage drift, by revaluing the crown. Instead, a slight devaluation was accepted in connection with the realignments of currencies in 1973. This was followed by entry into the European currency snake, where the crown was pulled up by the German mark, but only after Swedish costs had already been pushed up by the wage explosion.

In addition, the government aggravated the effect of the 1975 wage round by assuring that the resulting agreement would be for two years instead of one. It did so by settling for a two-year agreement for its own employees, which set the pattern for the rest of the public sector, before the private sector negotiations were completed. This was a

departure from the normal practice of letting the private sector, in which most of the production exposed to international competition took place, act as the wage leader. Once a two-year settlement had been reached in the public sector, it was extremely difficult for the private sector to continue holding out for a one-year agreement. Such an agreement would have made it possible to correct for the misjudgments of international prospects a whole year earlier, instead of locking the Swedish economy into large wage increases for two successive years.

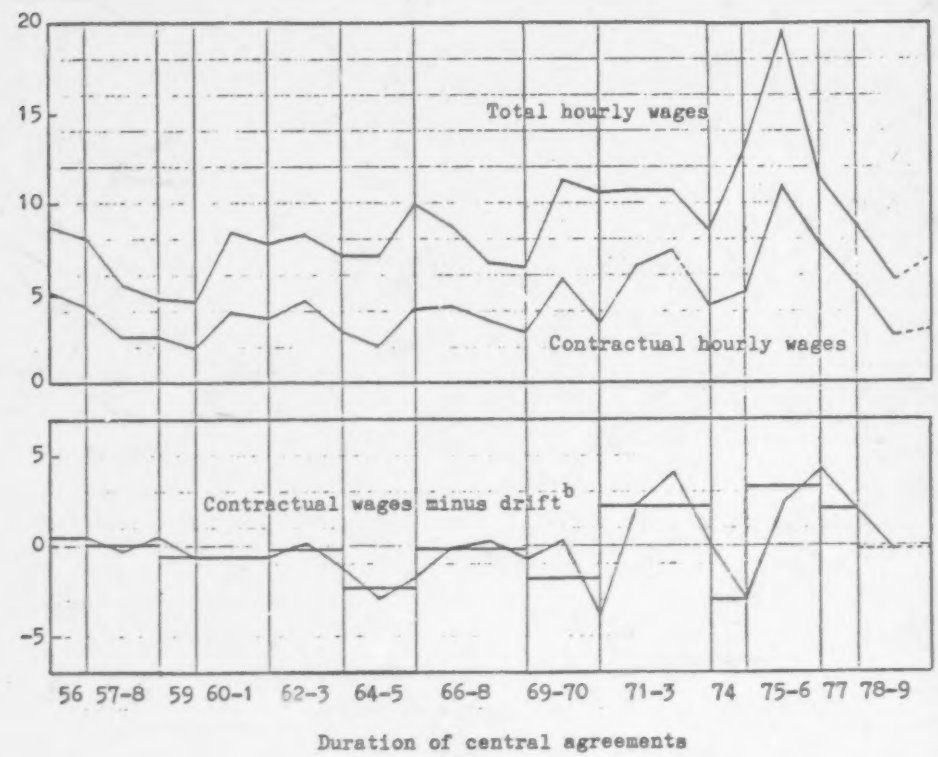
Thus, exceptional international circumstances and the government's responses to them seem to go a long way toward explaining the "wage disturbance" of 1975-76. However, it may only be the magnitude of the mid-1970s wage fluctuations that is thereby explained and not the pattern, for a similar pattern is discernible at least as far back as the early 1960s. The pattern is one of alternation between a period during which contractual wage increases provided in the central agreement is low relative to wage drift and a period in which the contractual increases are high relative to drift. We can refer to the former and latter as low and high agreement periods, respectively. The 1974 and 1975-76 agreements clearly display this pattern but so do earlier pairs of agreements, as shown in Figure 1.

This alternation seems to reflect efforts by LO to resolve the dilemma apparently posed by the conflicting requirements of external equilibrium and organizational cohesion by switching the order of priority in which it puts the two sets of requirements from one agreement to the next. As such, the resulting wage fluctuations need not pose a long-term threat to Sweden's position in the international economy, as long as the trend around which they occur is consistent with the requirements of external equililbrium. However, it has been argued that the earlier high agreements have constituted wage disturbances like the 1975-76 wage explosion, even if their magnitude was not nearly as great. According to this argument, their cumulative effect has been a decline in the size of the tradables producing sector. While the employment effects of this have been largely offset by a rapid expansion of the public sector, the result has been a growing structural disequilibrium in the payments balance.

If that is the case, then Sweden's central negotiation system has evidently failed to perform the function of an incomes policy that is most important for a small, open economy like Sweden's. My hunch is that it is indeed the case. Then the question is whether it is possible to overcome the structural disequilibrium without any significant changes in the wage determination system. The answer depends on whether the wage disturbances to which the structural disequilibrium is attributed are a consequence of the characteristics of the wage determination system itself or of the policy environment in which it operated. My further hunch is that they are both.

Finally, however, my hunch is that the Swedish wage determination system can be made to operate consistently with the increased investment required to overcome the structural disequilibrium only through institutional changes that are strongly opposed either by the employers or the unions. The former would sterilize some of the wealth effects of higher profits by extending the collectivization of savings which had been under way under the Social Democrats. The latter would permit greater wage differentials to occur by excluding from central agreements the whole range of provisions designed to implement solidaristic wage policy. Given the distribution of power between those with strong stakes in opposing either of these alternatives, the prospect for Sweden would seem to be continued stalemate and stagflation.

Figure 1. Percentage Changes in Hourly Wages, Contractual Wages, and Wage Drift, Adult Industrial Workers in LO. 1956-1979[a]



Sources: Wage data 1955-78 from LO Research Department.

a. Periods covered by individual central agreements indicated by vertical columns.

b. Percentage point differences between contractual increases and wage drift. Positive percentages indicate contractual changes greater than drift, and negative percentages indicate contractual changes less than drift. The average difference between contractual changes and drift during the period covered by each central agreement is indicated by horizontal lines.

Representative REUSS. Now, thanking you each for your very valuable contributions on the three Nordic countries, let's leave Helsinki, Stockholm, and Oslo and look at Pittsburgh, Fort Worth, and Buffalo. And, let's rule out waiting until 1984 and some sort of Democratic Party rising from the ashes. Let's talk about the period ahead when it is agreed by the President that we have a recession and it seems likely—or at least I put it to you as part of the hypothesis—that natural forces, if one doesn't interfere with them too much, may offer the most realistic hope of getting out of the recession, those natural forces being the automatic stabilizers in the budget. There will be a large deficit as a result of the Reagan recession and it is unlikely that either the administration or the Congress will want to sop up all that deficit and magnify the recession. So fiscally there will be stimulus. And from the monetary standpoint, even if the Federal Reserve maintains—as I believe it should—a reasonable control over the creation of new money and the supply of new money is therefore modest, the demand for new money will be less as a result of the recession and therefore interest rates will go down unless somebody pursues misguided policies of jiggering things to keep them up.

So the last best hope for a recovery is the stimulus which will occur through lower interest rates and a less restrictive fiscal policy.

Mr. Kouri said that kind of a situation in the world and in the United States is the most propitious time to try an incomes policy. Isn't that what you said?

Mr. KOURI. Mr. Chairman, I want to explain my point of view very carefully because it's important——

Representative REUSS. That's what we want to get into.

Mr. KOURI. It's an important point. I will start with the following remark, and this applies to the United States and all the Western market economies. It is vital, thinking in terms of the 1980's or 1990's of the industrial countries, in terms of growth, high levels of employment, and a low rate of inflation, that whatever is done in the coming year and the coming years, must not be done in such a way that we enter a new period of high inflation and inflationary resurgence of inflationary expectations, because in that case I believe we are really going to have a severe crisis in the world economy in the 1980's.

I say there are two ways we can go. One is to say let's have a prolonged recession. It will work. It will bring down inflation. There's no question about it. I think that is one policy that makes economic sense in the sense there's a consistent slow growth long enough for the inflation rate to come down and credibility of low inflation to be entrenched in the minds of price setters and wage setters. That is one way to go.

Then, if one argued this point of view, then one might argue, well, we're going to pay this high price in terms of unemployment and in terms of lost income now, but we're going to reap the benefit of high growth in the future.

Representative REUSS. That hopefully is not going to happen, although there is a growing risk of it due to the administration's mix of an expansionary fiscal policy and tight money policy which could keep interest rates too high for a real recovery to occur. The way

Treasury Secretary Regan flayed like a scared filly at M-1 and M-1B the other day however, suggests that the administration, like the Nixon administration, doesn't really want to put the United States, as England, through a Thatcheresque ordeal.

Mr. KOURI. That may be the case, but it would be consistent. It would be a consistent point of view to argue. And I was here a few months ago when Mr. Sprinkel was here and argued that the administration was determined in its efforts to bring down in a permanent way the rate of inflation in this country by means of monetary policy, and I think if that is all that is done—tight monetary policy is all that is done, then the only path to permanent stability of prices is through a prolonged recession. Helmut Schmidt said it took Germany 4 years of stagnation to bring the rate of inflation down.

Representative REUSS. They resorted to sending the Turks and Italians home, as well. We can't do that.

Mr. KOURI. So ruling that out as an option, it seems to me that there are very few cards left at the table and the only other option that I know of, leaving aside radical terms for monetary reform from this discussion, is to do something more directly with the process of wage-price setting.

And what I was addressing is that this may be a time when guideposts of the type that were applied in the 1960's could be produced and the theoretical justification for this is the following argument:

> That the problem of inflation is a little like the problem were people are standing in the stadium and nobody sees because everybody is standing. If everybody sat down, everybody could see very clearly, but nobody is going to make the first move because if he sits down he's not going to see anything. So there, what is needed is for everybody to sit down and everybody will be happy and will see the game in the stadium.

It's the same problem with inflation. If you just use aggregate amount policy, then who's going to make the first move? Firms will think "I'm not going to sacrifice my profits and cut by prices," and it's exactly the same in the labor market. So that's where income policy or guideposts come in, to make sure that everybody is playing his part in the process of disinflation.

I think it is mistake to argue, as many who have strong belief in the market system have—and I certainly do—that it's interference in the efficient functioning of the market process. That is not the case at all. You're saving the market system so you can efficiently accomplish a fast and efficient allocation of resources.

Representative REUSS. You've given us a fuller account, but I still think I got you right the first time. Putting to one side for the moment—and we'll return to it—just what constitutes an incomes policy, I think you have made the point that an incomes policy doesn't work when there's boiling inflation because that's like asking the sea to roll back. It isn't needed when you don't have any inflation, so why fool around with it? But at a time when you are working your way out of a recession and thus new inflationary pressures may be generating, it may be worthwhile to show credibility and to engender kind of a social contract to have some sort of an incomes policy.

Mr. Martin, do you have any difficulty with that formulation?

Mr. MARTIN. No.

Representative REUSS. You said that it won't do in a time of boiling inflation to have an incomes policy and it isn't needed when you don't have any inflation, but then I think you said that it might be a good idea when you're working out a recession to have an incomes policy which we'll define in a minute.

Mr. MARTIN. As you spoke, I found myself assenting to that.

Representative REUSS. I want to do these things one at a time. Mr. Lange, do you have any difficulty with where we are at this point in the dialog?

Mr. LANGE. No; I have none with the only exception that I'm not entirely in agreement that that is the only time when it's appropriate.

Representative REUSS. Well, we note your more sympathetic view toward an incomes policy, though I'm surprised to note it because you in your discussion of Norway, I thought, took a somewhat dour view of it.

Mr. LANGE. Let me be very clear on that point and very brief. From my comparative analysis, it is not the case that under conditions of very high growth and the expectations of very high growth over an extended period of time—which unfortunately we are not looking forward to for the moment but which was for instance, the case in the late 1950's and early 1960's—that incomes policy becomes unnecessary. In fact, those are conditions when incomes policy breaks down and when such a breakdown can have rather disruptive effects. The experience, for instance, in the Netherlands in that regard is illustrative. Under those conditions, everybody thinks we can do a little better than we have been doing, so let's get out of this maintenance of relative shares business and start fighting a little harder and we don't want to be in this constrictive package, and that can sometimes damage the economy to fully utilize that period of growth.

So I would just say there's an additional period when it may be both desirable but difficult to have an incomes policy, but otherwise, I'm entirely in agreement with you.

Representative REUSS. Right. We are in a recession which nobody wants; Republicans and Democrats alike would like to get out of the recession; Republicans would like to get out of it perhaps even more than Democrats—so the question is, what contribution can an incomes policy make?

Now a word on incomes policies. When I use that term, I think of some set of policies much, much short of wage-price freezes or compulsory across-the-board controls, but in which wages would probably include some inducement for labor to go to income bargaining rather than long-term bargaining with built-in cost-of-living increases and guideposts; and as for prices, it includes some form of standby price controls on major sectors in the economy—in this country, for instance, it could cover products made by the largest 100 or 500 corporations. This is for standby controls, not imposed. And for credit, some sort of voluntary arrangement, ideally with the banking system, to be a little less prone to making inflationary loans—as for commodity speculation, as for conglomerate takeovers—and have a little greater propensity for making anti-infla-

tionary loans as for real capital investments, agricultural and business purposes.

That is what I think most people, including myself, would think constitute the range of options when they talk about an incomes policy.

Having defined what I mean by an incomes policy, let's look at some of the lessons that we may adduce from the Nordic experience.

In the Scandinavian countries, incomes policies seem to include price controls over at least some commodities, but no explicit wage controls. Is that a reasonable model for our country? Do you think we could do well to concentrate on prices and leave the wage bargaining to the private sector? I think that's what your testimony indicates was done in these countries, but if I had it wrong, please correct me.

Mr. LANGE. It is true that wage bargains are reached in the private sector—that is, without imposed wage agreements; but the level of influence played by the Government in setting of those wages and in the reaching of those agreements is enormously large.

Representative REUSS. Isn't that due to sort of a social contract tradeoff? Don't the unions—which, of course, are very much more centralized than in this country—consider what is being done about price policy, taxes, and tax rate changes, about social benefits, including social security, and about exchange rate policy, in making up their minds whether they should be reasonable in their wage demands?

Mr. LANGE. No; that would suggest more autonomy between those two aspects than is the case. That is, those things are decided and have been increasingly decided together as a package. It is not as if the government is deciding one set of things and the unions are saying under those conditions what they would do. It is much more a situation of sitting in a forum in which there is always the agricultural sector, the banking sector, the employers and the government represented. There is an entire package hammered out so all the variables are on the table, so to speak, at the same time.

Representative REUSS. Would the specialists on Sweden and Finland indicate whether by and large this social contract, multifaceted package approach which Mr. Lange says is true in Norway, has also been true in Finland and Sweden?

Mr. KOURI. Let me first address the question that you posed, Mr. Chairman, whether wages or prices should be controlled and what is the lesson we can draw from the experience of the Nordic countries. If I may refer to the appendix table 1 of my prepared statement where I report the rates of increase of import and export prices for the Nordic countries, let me note that from 1951 to 1970 in Finland, for example, the prices of export and import production declined at an average annual rate of 1 percent, which meant, now putting aside the devaluations that did take place, the prices for the manufacturers are basically in accord with the world market.

So if it was the case in the United States that the price of steel and the price of automobiles and all manufacturing products were exogenously given in the world markets, the United States would not increase the price of steel but it would have to take the given

price, there wouldn't be a problem in terms of price determination. The price problem would be solved right then without government controls of any type, and the American steel industry could not increase wages without full knowledge of the fact that they wouldn't be able to pass on this higher wage cost in prices and their profitability would suffer.

So in this case—and it was in the period from 1951 to 1970 in the Finnish case, the price problem was solved by the world market. The prices were stabilized in the world market. Of course, there was a dramatic switch in this regard that occurred in the 1970's in the Nordic countries.

In the larger economies such as the United States, a corporation that experiences an increase in its wage costs can pass on those wage costs in prices. As a first approximation, we can say that the price inflation is directly derived from increases in wage costs and increases in raw material costs. So if you get a handle on wage costs and the raw material costs, you basically have a handle on price inflation of most manufactured products.

There are some variations in profit margins. As we look ahead in the United States, there isn't going to be that much pressure on the raw material side. Oil prices will probably be quite stable or decline in real terms. So leaving aside erratic prices such as agricultural prices, what we end up with is the rate of increase of nominal wages on one hand and productivity on the other. To reduce the basic rate of inflation, we must reduce the rate of wage inflation or increase the rate of productivity growth.

So the kind of policies that we need at this juncture of this economy are policies that in a sustained way reduce wage inflation or contribute to growth in productivity. And in this context I think guideposts can serve a useful role in setting a timetable for reductions in rates of wage increases in the settlements, and the argument why this might work and help is that they will assure everybody that this is an activity where everybody is involved and everybody is reaping the benefits of that activity.

Representative REUSS. Well, isn't the one lesson that one can distill out of the Scandinavian experience—which is admittedly ambiguous and spotty—that if you are going to get labor to be reasonable about wage settlements, the government and the society have to enter into some sort of a social contract which relates not just to wages but to prices—executive compensation, credit price and availability, tax rates and structures, social problems and social security, foreign economic and exchange policies; the works. And hasn't that been the distinguishing feature of incomes policies when they have, and to the extent that they have appeared to, work?

Mr. MARTIN. Mr. Chairman, I'd like to say you have taken the words right out of my mouth.

Representative REUSS. Why do you say that?

Mr. MARTIN. Simply that while one can distinguish between the degrees of explicitness of the social contract and the degree to which the government and other parties actually literally get around a single table at the same time and make a deal—that's not true of the Swedish case although I guess it's literally true of the Norwegian case. I think in both cases—and to some extent I think

in the Finnish case as well—in a number of periods that the broader description you give is correct of a deal which is made which is not just about wages, but about wages in the context of everything else.

When you mentioned incomes policy before, the thought that jumped to my mind was, yes, there are incomes of all sorts and they are affected not only by a price and wage setting in the labor and product markets, but as well by all sorts of things such as income maintenance, social security, things such as the tax system in particular; and one thing I'd like to add on this is that in recent years the impact of income taxes on aftertax disposable income has become increasingly a part of the discussion around what is an appropriate agreement or what is appropriate in terms of the social contract. And even in Sweden where, as I say, there's no explicit bargain between the government and the unions and employers, successive governments have made adjustments in income tax scales designed to reduce the level of nominal wage increases needed to achieve a certain amount of real wage increase. But the possibility of a deal or not depends very much on the distributive profile of these income changes. What has happened in recent years in Sweden is that there has been a succession of changes in the income tax scale which have been inegalitarian in their direction and that has made it very difficult to arrive at a kind of implicit social contract. I certainly think from the experience in the Scandinavian countries and in other countries as well, that in order to get an income policy, you have to talk about a lot of other things besides wages and prices.

Representative REUSS. Mr. Lange.

Mr. LANGE. If I might just address this issue because I think that while one may agree that from an economic standpoint the only thing necessary is to lower wage inflation and increase productivity, I think what we are saying is—at least what I'm saying and what I hear Andrew Martin saying about the Nordic experience—in order to achieve those narrowly defined economic objectives, other policies must be undertaken to create a package which is sufficient to win the consent of the actors.

If we take Mr. Kouri's stadium analogy, the problem is you still need to find the mechanism to get all those people to sit down and you cannot simply stand up in the middle of the stadium and say, "Now everybody sit down." It may require ushers. It may require some sense that other people in the stadium will sit down and will stay down, and I think the fact about staying down is very important. If I can then proceed back up to the discussion of the United States, I think that while the economic circumstances may be particularly propitious for an incomes policy in the near future, hopefully so, given the scenario that you sketched, the political conditions are particularly impropitious. And I don't mean by that only who is in Government, but that present governmental policies are creating a sense of distrust between sectors of the society, a sense of grasping for shares, a sense that certain sectors are losing shares. An incomes policy which had as its premise the maintenance of shares at the time that that policy was implemented would consequently face a significant political obstacle, precisely the obstacle

that groups feel the share they have is unfair and one which they have only recently lost.

So I must say that while I'm an optimist, if you wish, from the standpoint of the efficacy of such policies and the appropriateness of such policies. I'm definitely a pessimist from the standpoint of the political conditions for those policies. And, unfortunately, as a political scientist, I put more weight on the political factors than on the economic with respect to this issue.

Representative REUSS. Well, I think one has to look at both and I think this dialog is making great progress as far as I'm concerned. We seem to be saying that economically the months and years ahead would be a pretty propitious time to try out that shy bird, an incomes policy, which doesn't always work but occasionally does some good. But then we have said that you certainly can't do it politically at a time when the Government has just redistributed income in a regressive way and when labor has just come to Washington in the biggest labor march in many generations in outrage and in diametrical opposition to everything the Government is doing.

As Mr. Martin said, in 1984 but not before. I wonder though if we really are tied to a log in a kind of "Perils of Pauline" scenario—because it really wouldn't be good to say nothing could be done until 1984 because it isn't a fact. Looking at recent elections ranging from Norway to Greece, voters nowadays seem to just love to throw out whoever is in power, conservative or socialist or whatever it is? That's what the voters in this country did a year ago.

It it possible that this lesson will not be lost on President Reagan and his political advisers? And is it possible that, just as President Nixon changed around quite dramatically in 1971—maybe not altogether in a wise direction, but he did change—that the administration presently in power might be led into some sort of a de facto, ad hoc, minicompromise with the Democratic opposition which has control more or less of the House of Representatives? It could make a stab at the kind of social contract, multifaceted bargain which could induce labor to settle for something less than the current 9 percent wage increase rate at a time of zero percent productivity—which I think you all would agree does not bode well for future inflationary activity. Is such a thing possible?

Mr. KOURI. Mr. Chairman, if I may address the economics of this issue, last time when I was here discussing the policies of the administration I noted with perplexity the contradictory policies advocated and pursued by members of the administration. As I look around today, we have at least three groups whose analysis of the current situation and the policy implications that they draw from the current situation are quite contradictory. You're now adding a fourth element into the picture. First, on the supply side, if they're serious about their theory, they should be advocating a further tax cut in this situation. Next, we have fiscal conservatives who would be arguing for further reductions in Government expenditures and increases in taxation, and third, we have the monetarists like Mr. Sprinkel and the Federal Reserve, who should argue, if they're consistent with what they have been saying all along, that we should just be pursuing a policy of steady decline in the rate of monetary growth.

If the monetarists win—and I think that's really where the action is in terms of aggregate activity—if the Fed pursues a policy of lowering the rate of growth in the money supply in light of the rate of inflation, 9-percent wage settlements, and zero productivity growth. It is not possible to recover before inflation comes down.

So something has to give in. The supply side miracle has not occurred and is not likely to occur. So the problem where we are now politically, if I may enter a political discussion here—and I noted it earlier—is that it's a no-win situation because if the administration now comes in and says we're going to change monetary policy and we're going to have more expansionary monetary policy, there's going to be a collapse of confidence in the financial markets and foreign exchanges and there's going to be a wild speculation in foreign exchanges.

Representative REUSS. If I may say so, I think you are being too absolute. The administration does not have to say, "Turn on the printing presses; we guessed wrong and let's have a lot of easy money." All the administration has to say is that, for the immediate present, we don't ask for a further tightening of money; and, with a firm but not increasingly tight control over the money supply, we favor letting the recession generate the lower interest rates which would thus be generated.

If they do it right, it can cause much less turmoil than did Secretary Regan's call for revving up M-1B to the target growth range for this year.

Mr. KOURI. Yes, I agree. I was being too strong in saying that no reversal of policy can take place without upsetting the financial markets, but I do think that the administration is boxed into a corner—because of what has been said before and because of the nature of expectations in financial markets and the international foreign exchange markets and so forth—it's not possible to have a reversal. The Nixon reversal of the early 1970's was disastrous in terms of its consequence and it's very much in the minds of people in the international economy.

So I think it comes to this question of whether a new idea such as incomes policy might be the way out. I think from the economic point of view it's eminently sensible and might be a way to stimulate the economy without reigniting inflation psychology, but whether the political preconditions are there, I'm very skeptical on that view.

Representative REUSS. Incomes policy does not stimulate the economy. Incomes policies prevent a stimulation of the economy, either from fiscal or monetary means, from reigniting inflation.

Mr. KOURI. That's right.

Representative REUSS. Congressman Richmond.

Representative RICHMOND [presiding]. Gentlemen, from what you have just given us, incomes policies are working in these various Scandinavian countries fairly well. Inflation is relatively in hand, at around 8 percent I gather. The standard of living is high as well.

Mr. MARTIN. They work reasonably well in the sense that they provide an additional means of stabilizing inflation, which has contributed something to the stabilization of the economies. I think the best case I would make is where they haven't worked well, you

can make a reasonable argument that it's because the other economic policies have been contradictory to their working well.

Representative RICHMOND. Would you say in Sweden, Norway, and Finland right now that the economies are relatively stable?

Mr. MARTIN. I would not say that about Sweden, no. I would say it isn't precise, because economic policies in 1979 were such as to make it impossible for an incomes policy to work.

Representative RICHMOND. Can you give me a correlation between Scandinavia and the Japanese system?

Mr. KOURI. Congressman Richmond, the Japanese system of wage settlements, of labor market contracts, is quite unique because of the lifetime association between the workers and their firms.

Representative RICHMOND. That only happens in 37 firms.

Mr. KOURI. Yes, but that is the——

Representative RICHMOND. Those are the dominant firms?

Mr. KOURI. Yes. So in the industrial sector Japan has what Western countries would like to have but don't have—a degree of flexibility in wages in which wages are tied into the profits and revenue generated and in that kind of a situation——

Representative RICHMOND. Certainly such profit sharing plans is something we ought to look at in our country.

Mr. KOURI. But that does not exist in any of these countries.

Representative RICHMOND. I just can't think of how we can institute an incomes policy in this country where we have an administration so totally admantly against any type of regulation; yet, as the chairman said, we have to think of doing something now and not wait until 1984. As a practical matter, you have a setup that's totally dominated by the administration, as we'll see in the vote that's taken today. We've got an administration that would sooner go down in flames than change their hands-off policy on industry. How are we to adapt some of these wonderful things that are happening in Scandinavia and in Japan to our own economy? The chairman knows exactly what we ought to do. I would have voted for him for President any number of times because he knows exactly how to turn the economy around, but with this administration we have and the Senate agreeing to a hands-off policy, what can we do?

Mr. KOURI. Congressman Richmond, you made two statements. I do want to disagree with your statement that Scandinavian economies are doing wonderfully. Sweden is in a miserable situation. It's inexcusable that a country such as Sweden has done as poorly as it has, but Sweden is in a crisis situation.

Representative RICHMOND. A crisis situation in inflation?

Mr. KOURI. In terms of complete stagnation of the economy, enormous deficits.

Representative RICHMOND. What is the rate of unemployment?

Mr. KOURI. There's no unemployment because the Government is employing everybody who would otherwise be unemployed and is paying their wages by borrowing either in the domestic or international markets. I was in Sweden only recently and one of their leading economists stated in a meeting that America doesn't need Mr. Reagan; Sweden does. So the Swedish situation and the Scandi-

navian situation is rather more complicated than you indicated in your statement.

But I wanted to comment on this statement that incomes policies are a way of regulating the economy. I'm not personally in favor of this approach to incomes policy. There are collective or centralized ways of regulating the way labor markets work and I don't think that is the only kind of incomes policy we can have. Incomes policy in a situation where we're going from high inflation to low inflation is not interfering with the workings of the market process. It is aiding it. It is a way of disseminating information, getting people to agree in the way that serves the interest of everybody, and making the market system work better. So I don't think it is necessarily, in terms of economics, a contradiction between the kinds of incomes policy that we're discussing and the free market philosophy that this administration is for.

Representative RICHMOND. What do you think this Congress ought to do to put America back on the track based on your studies in Scandinavia?

Mr. LANGE. I don't want to respond exactly to that, but I do want to respond to the question of whether incomes policy is the thing that ought to be done.

In my own view, thinking about it in political terms, since we seem to be basically engaged in that at the moment, I think it might be very unfortunate if incomes policies were attempted by this administration or imposed on this administration through some agreement with the Congress, because I don't think this administration is capable of delivering in those other aspects which would be necessary to make those policies successful. And under those conditions, we'll get into a situation where policies which could be effective and which I think under other political conditions would be effective would be discredited to such an extent that it would become impossible for a Democratic administration to implement them subsequently.

So I must say that not only am I skeptical about the ability to implement such policies in the present period, but I would also be rather concerned were they in some sense imposed under conditions which were not desirable for their effective use. I'm perfectly willing to entertain the idea that they don't work or would not work in the United States, but I think it would be very unfortunate if they didn't work for conditions that have nothing to do with the policies but with the political administrators of those policies.

Representative RICHMOND. Well, are you referring to the——

Mr. LANGE. To the present administration.

Representative RICHMOND. The last time we tried it, it did not work because the administration really did not want it to work.

Mr. LANGE. That's right.

Representative RICHMOND. And you are saying that this time the administration would not want it to work either; and I agree with you.

Mr. LANGE. Sometimes I guess we just have to be patient. You asked what can the Democrats do. I guess under these conditions, maybe those natural political forces which you spoke of, Congressman, need to play themselves out.

Representative RICHMOND. Mr. Kouri, let me ask you one more question. You indicated that a prolonged recession in the United States would be the most effective way to get rid of inflation. Now what happens with a recession and a government printing Treasury bonds every day of the week chasing its own deficit? Sure, a recession is deflationary, but hand-in-hand with the recession, you are going to have the Government printing more money because the more recession we have, the more deficit the Government will have to finance. Now how is that going to reduce inflation?

Mr. KOURI. I understand the question. Let me say I did not say that recession is the most effective way of bringing down inflation. I said that there are two ways that we know from past experience, from economy theory and economic research, to bring inflation down; and one is a prolonged recession.

Now the Great Depression brought prices down, not only the inflation rate, but it brought the absolute price level down. There's no question it works in this way, but, of course, I know some other efficient ways.

Representative RICHMOND. I am assuming that half your statement is right, that a 2- or 3-year recession in the United States could be deflationary. What I want to know is, how does that work out in the face of the Government having to finance an enormous deficit which is terribly inflationary?

Mr. KOURI. Congressman Richmond, your question has to do with the mix of fiscal and monetary policies in the process of disinflation. To bring inflation down by means of tight aggregate demand policy, we can do it in two ways. We can have tight monetary policy or tight fiscal policy or a combination of the two. What is happening now is that monetary policy is tight and at the same time on the fiscal side we have a reduction in tax revenues, the tax rates, which is much more than a reduction of Government expenditure. So we have a deficit in the budget and this means that the burden of this inflation falls on those components of aggregate demand that are most sensitive to high interest rates that this policy mix generates. I think that is a most unwise strategy.

If the administration from the very beginning opted for a strategy where we would put all impetus on bringing inflation down, they should have postponed the tax cuts. They should have put more of the burden of this inflation on aggregate demand policy on the fiscal side and less on the monetary side. We would have lower interest rates. We would have more investment activity taking place and more of the burden falling on consumption rather than investment.

So I think that is the problem as far as the deficits are concerned. You're absolutely right. A recession means higher budget deficits and that crowds out private investment expenditure.

Representative RICHMOND. I want to thank you gentlemen for coming this morning. I think we have to go into session at 12 noon and I know the chairman has to be there. I have learned a great deal this morning and I just wish we could come up with some practical way of applying it to the American political and economic situation. I have a feeling there is not any possibility of doing that right now.

The hearing is adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

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